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COMMENT AND OPINION

A Lesson Learned from an Emergency

NOT long ago we were privileged to listen to Mr. W. D. Hurst, city engineer and commissioner of buildings of the City of Winnipeg, telling the story of Winnipeg's flood emergency organization. He recounted how the City Council delegated complete powers to a committee consisting of the city engineer, the general manager of the Hydro-Electric System, the fire chief, the chief of police, the medical health officer, and the supervisor of emergency housing. This committee was given authority to add to its membership and later it included the deputy city engineer, the chief engineers of the Winnipeg Electric Company and the Manitoba Telephone System, the general manager of the Greater Winnipeg Water and Sanitary Districts, the director of the Division of Sanitary Engineering (Ontario Department of Health), and the director of the Council of Social Agencies. The registrar of the Association of Professional Engineers of the Province of Manitoba was appointed secretary of the committee.

Under the heading "Looking Backwards" Mr. Hurst, the chairman, included these words,—

> One thing I would do if I were faced with the same problem again would be to see that supplementary adequate accounting facilities were provided. A competent financial man to assist the committee in setting up proper emergency accounting during such a period is highly desirable and necessary. However, owing to limitations of time, he should not be placed in a position of determining whether an expenditure should or should not be made.

In making plans for civil defence or against an emergency, would it not be useful for our civic authorities, or the Canadian Red Cross Society on behalf of the civic authority, to see that the nucleus of such an accounting requirement was set up? Here is an opportunity for members in every community to do a little thinking for preparedness.

Mr. Hurst's report is a most interesting story and could well set a general pattern for the control of an emergent situation. Each member of the committee was a fully qualified man in his own field and, what we should think was equally important, could call on his own well-trained associates to divide and organize relatively untrained persons at strategic points. This is no doubt one reason for the success gained in the Winnipeg effort.

It might be added for the record that this report by Mr. Hurst was not prepared for, nor read to, an accounting group specifically. His listeners were members of the Institute of Public Administration of Canada which is comprised of officers of government, both federal and provincial, officers of municipalities and members of the staffs of universities.

National Defence Committee on Accounting

THE following announcement of the American Institute of Accountants suggests a further step which might now be taken by us against a general emergency.

> A special nine-man National Defence Committee to consider accounting problems arising from the present emergency has been created by the American Institute of Accountants.
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> Named to the committee were George D. Bailey of Detroit; N. Loyall McLaren of San Francisco; and William M. Black, Paul Grady, Harry E. Howell, Leslie Mills, Maurice E. Peloubet and Andrew Stewart, all of New York City. Institute President J. Harold Stewart of Boston will act as chairman.
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> All members of the new committee served in top government posts or with the armed forces during World War II.
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> The group will study such problems as war contract procedures, renegotiation and termination, cost definitions, tax policies, and the effective use of accounting personnel, and will submit its recommendations to the appropriate government agencies.

News of Our Members

FROM time to time, we have been asked why we restricted our "Professional Notes" columns to changes in professional partnerships etc. and did not enlarge its sphere to include items of interest concerning non-practising members and others not directly concerned with the practice of the profession. Our feeling has been that it would be most difficult to give fair and adequate coverage to this type of news and that it would be unfair to our own staff to place upon them the responsibility of gathering the items.

As a result of recent informal talks with a number of members, who were at Charlottetown, we are prepared to try out such a column on an experimental basis and the first notes of this type appear on p. 175 of this issue. We shall not, however, seek out the items through the medium of a clipping service but will rely upon information which comes to us directly from an authenticated source or otherwise comes to our notice from our ordinary reading of publications. It is emphasized that the Editorial Committee or the staff will take no responsibility for mistakes beyond their control or for omissions and that they reserve the right to decide from time to time the items which may or may not be considered newsworthy.

We shall count upon our members and other readers to furnish the information and we might again stress the desirability of the use of the letters "C.A." or the words "chartered accountant" by those whose promotions or moves or other activities are announced in the public press.

We bespeak the cooperation of the provincial members of the Magazine and Publications Committee in this effort. They can be most useful. For the benefit of our readers, we give below their names and addresses,—

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Differences Between Audits Of Small and Large Businesses

By J. R. M. Wilson, F.C.A.

There are four types of errors in accounts, but their relative significance is not the same in the large business as in the small business

IN CONSIDERING the audits of small and large businesses we must first define what we mean by a small business or a large business. If you could range all the businesses in Canada in order, you would have at one end of the scale a business owned and operated by one man with perhaps only 50 or 100 transactions a year. At the other end of the scale would be a large corporation, with thousands of employees, doing business in many locations across the country, with more than 50 million transactions a year. Both of the end points on the scale would represent extremes and, like any extremes, such are not typical of the problems we have to meet in day-to-day practice. Yet, I suggest, there is an advantage in studying these extremes as by doing so we may see more clearly the distinctions between the audits of small and large businesses — and distinctions can become very blurred if we look at more intermediate and therefore more representative specimens.

I do not propose to discuss the question "What is an audit?" but I suggest that for our immediate purpose we might recognize that all audits have one thing in common: namely, to detect errors. That, surely, can be agreed upon — and when the day comes that there are no more errors, there need be no more auditors. Some would feel that such a result would mean the arrival of the millennium — and the two events will probably be coincidental. In the meantime, the accounting records of the world contain plenty of errors and there is plenty of work for auditors.

Errors are not all of the same type, however. Some are intentional and some are unintentional. Some are material and some are immaterial. Some are mechanical, some involve principle. I think that for our purpose we might discuss four main types of errors which we meet as auditors.

The Four Types of Errors

First: The unintentional clerical error: these are due to the fallibility of human beings and abound in all businesses. Wherever two or more amounts are added together or subtracted or where an amount is copied, or where amounts are multiplied or divided, the opportunity for error exists. We all know these

A paper read to the 48th annual meeting of the D.A.C.A., Charlottetown, August 25, 1950

kinds of errors, because we all make them ourselves.

Second: The intentional error made to cover a fraud: very seldom do bookkeepers steal money and charge it to their own account. Instead, records are falsified to cover the embezzlement Sometimes false entries are made in the accounts; sometimes an entry is not made which should be.

Third: The intentional error made to perpetrate a fraud: for example, misstating inventory values, accounts receivable or accounts payable — either made by management or at its instigation — in order to show a better or worse financial condition than is actually the case.

Fourth: The error (either intentional or unintentional) resulting from the wrong application of accounting principles: for example, charging repair costs to fixed asset accounts.

The Unintentional Clerical Error

The audit technique we employ are designed to uncover all these four kinds of error, *provided* that the errors could be significant enough to affect the general validity of the accounts. This proviso is, of course, all-important. In the case of the very small business, one or two unintentional clerical errors might substantially affect the validity of the accounts. In the case of a large company an equal percentage of clerical errors might have little effect on the final results. In the latter case, the law of averages is at work — in the case of the small business there are not enough transactions to count on the law of averages cancelling out errors of overstatement and errors of understatement. If the average chance of error is 1 in 50 and there are only 100 transactions, then in all probability there are 2 errors in the accounts, but both these errors may affect profits or working capital in the same direction. If there are 1,000,000 transactions, however, and the same probability of error holds, then there may be 20,000 errors in the accounts but we can be sure their cumulative effect will not be all in one direction. You can throw heads twice in succession when you toss a coin — you can't throw heads 20,000 times in succession. Of course, the frequency of error in a large company should be very much less than in a small business, as the work of one employee is checked by another and the mechanical bookkeeping devices which would be employed also reduce the chance of error.

If, then, we only had to concern ourselves with unintentional clerical errors, it would follow that in the case of a very small business it might be necessary to check practically all transactions in detail; in the case of the very large company it would be necessary to check only the very large transactions — that is, those transactions which are so large that an error could affect the total profits or working capital appreciably. In the case of smaller businesses with 1,000 to 10,000 transactions a year it is not ordinarily necessary to check all transactions in order to satisfy oneself as to the validity of the accounts. A test should be sufficient to satisfy oneself that the accounting work is being accurately performed (within the limits of human fallibility) provided that the test covers a sufficient number of transactions to comprise a reasonably comprehensive sample and embraces the larger transactions.

The Intentional Error to Cover a Fraud

The second type of error (that is, the error to cover a fraud) has one point in common with the clerical error; namely, its effect can be much more serious in the accounts of a small company than in the accounts of a large company. This is due to the phen-

omenon that "wine, women and song" can cost the cashier of the small business just as much as they do the cashier of the large business. I think we will all agree that the main purpose of an audit is no longer the detection of fraud. But in the case of the small business the detection of fraud must always be kept in mind, as the undetected fraud can seriously distort the truthfulness of the financial statements. Then, again, the relative frequency of fraud is probably greater in the case of smaller businesses than in the case of larger businesses as the better internal control in the latter both reduces the opportunity for fraud and increases the chance of detection.

It follows that in the audit of smaller businesses greater attention must be paid to those audit techniques which would detect misappropriation of the proceeds of cash sales or miscellaneous revenues, the padding of payrolls, the kiting of cheques or any of the similar ways in which dishonest employees acquire additional remuneration to finance the high cost of extra-curricular pleasures. In the case of the larger company, the audit may well be limited to an enquiry as to the internal control and a very brief test of transactions to satisfy the auditor that the internal control said to exist is actually functioning.

The Error to Perpetrate a Fraud

The third type of error (the intentional error to perpetrate a fraud) is common to all types of businesses — except, probably, the very largest. Each of us has come across examples of this in the case of smaller companies. In the case of larger businesses, the chance of such error being successfully perpetrated decreases, although the *McKesson & Robbins* case serves to remind us that even in larger companies it re-

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mains a possibility. For this reason, the same auditing techniques which will detect such an error (i.e., those which used to be referred to as comprising a "balance sheet audit") are applicable to both large and small businesses, although in the case of a larger business it is frequently possible to reduce the extent of detail required. For instance, in the case of a small business it may be necessary to confirm practically 100% of the accounts receivable, while in the case of the larger business a test check of only part of the accounts receivable may be sufficient to satisfy the auditor as to the substantial correctness of the total.

The Error in Accounting Principles

The fourth type of error (the wrongful application of accounting principles) is also common to all businesses. Again, the chance should decrease as the size of the business unit increases, due to better trained accounting personnel, internal control and, in the case of some larger companies, the use of accounting manuals. For this reason it may be necessary to make a 100% check of additions to fixed asset accounts and charges to repair accounts in the case of a small business while in the case of a large business an examination of the system of internal control and a test of the transactions will usually suffice. On the other hand, there is one aspect of the matter in which the effect of the wrongful ap-

plication of accounting principles may be more serious in the case of the large business. In the case of a small privately-owned business it may not be too serious if the annual profits are $8,000 this year and $12,000 next year instead of $10,000 each year even though this represents an increase of 50% in the company's earnings. In the case of a large public company it might be more difficult to have an error in accounting principle affect the net earnings by this amount, but even a lesser increase in earnings might be more important to the shareholders of that company for, whether we like it or not, shareholders and prospective shareholders convert the net profit shown to "earnings per share" and give the resultant figures considerable weight in reaching a decision to buy, sell or hold shares in the company.

Conclusion

A review of the four types of errors shows what we all knew anyway — that in the case of small businesses a detailed check may be necessary whereas in the case of a large business test checks may be sufficient. But I think it also shows that as the size of the business unit increases, not only does the test check become more appropriate but after a certain stage is reached:

(1) The test check is primarily designed to establish that the internal control is effective;

(2) Auditing for the detection of fraud becomes of less and less importance;

(3) Auditing to establish that correct accounting principles have been applied consistently becomes of more and more importance.

In these remarks I have spoken of auditing techiques as though auditors were cold-blooded people who applied certain techniques to a set of accounts and came up with the answer that they were correct. But auditors are not so cold-blooded as all that and a good auditor always remembers that he is auditing people, not records. In the case of a smaller business the auditor usually has a better opportunity for knowing the people whose work he is auditing. If the smaller business is in a smaller city he has the advantage of knowing his clients socially and seeing how they live and behave (or misbehave) outside of business hours. Even in the larger city, the auditor is more likely to be closer to his smaller clients for he will probably be called in to advise them on a hundred and one things not related to auditing. The knowledge gained from each of these contacts will certainly affect the judgment of the auditor as to what techniques he should apply and how extensive should be his tests. For this reason, while it might be possible to lay down a standard audit programme for a very large corporation which most auditors would be prepared to accept, it is not possible to do this in the case of the small business. What the auditor knows about his client before he starts the audit and what he finds out as the audit progresses will certainly affect the audit programme.

Staff Problems
Of the Small Accounting Firm

By Milton E. Mandel, C.P.A.

The selection and development of staff personnel

ONE of the first problems confronting the small practitioner is the choosing of the right man for the position he has open in his office. It is usually advantageous to engage the services of a young man, both in years and experience, and eager to learn and pursue the practice of public accounting.

Background of Applicant

Among the tests in the selection of a member of staff personnel should be his college background and scholastic record, his personal characteristics and his professional aptitude. He must also be psychologically and temperamentally suited to the principal and the other members of the staff. It is amazing how many young men who have attained high scholastic records in college fail to grasp and apply the very theories learned in college, in an essential, practical application. The American Institute of Accountants has recently developed a series of accounting and other aptitude tests, which, if used, could be of material assistance in the elimination of those not suited to the public accounting profession.

In interviewing some men for a position on my own staff, a few weeks ago, a young man came to my office for an interview. Before I had an opportunity of asking any questions, he told me that he had had four years of very fine CPA experience, that he could handle any assignment, and that he knew every phase of accounting. I arched my eyebrows, for in my 20 years of accounting experience, I am frank to admit that I do not know everything there is to know about accounting. I asked the young man, "Everything?", and he replied, "Yes, everything. It is only debits and credits, and after that, it's nothing." I shall leave to you the question of whether or not I hired him.

Training Programme

This young man will soon learn that an accountant's success will continue to depend upon aptitude for the work, attitude towards clients and others self-discipline, sound judgment, and *continued* reading and study in the field of accounting.

No public accounting firm is any better than the quality of its personnel, from

A paper read to the annual meeting of the New Jersey Society of Certified Public Accountants, Atlantic City, April 1950

the principal right down to the newest junior. To develop a good staff, the principal must inaugurate a training programme, which will be of benefit both to the staff and to the practitioner. Because of the lack of time and the limited number on the staff, it is not possible to enter into a well-defined formal programme for beginners. From the moment a beginner is engaged, he is usually sent out on an assignment with a senior. His activities and work will be closely supervised, guided, and watched. He is encouraged to ask questions of the senior. Every effort is made to make the new member of the staff feel relaxed and "at home" in his new surroundings. A number of sets of workpapers are made available to him for review in order that he may acquaint himself with the various types of services rendered and methods used by the firm.

It is expected that such a man will not be productive for quite some time. An attempt should be made to have him assist every man on the staff, so that his experience will become diversified; and he should be given a helping hand by all of the other members of the staff. This type of "on the job" training should give the junior a well-rounded knowledge of practical auditing procedures encountered on assignments.

The training of a new man is a big and difficult task, if he is to become worthwhile both to himself and to the principal. The problem of training the junior should not be the only phase of the training programme. Both he and the more experienced men must be advised as to the importance of keeping abreast on technical matters. Current publications on accounting, auditing, and taxation are passed on to all staff members.

Theory and Practice

A man just out of college is usually all imbued with ideals, theories, and enthusiasm. He should be constantly reminded of the importance to develop a sense of imagination, ingenuity, judgment, and to think constructively. The mere preparation of a financial statement that is arithmetically correct is not a test of accounting competence. Far more important are the interpretations and conclusions that can be derived from these statements and from which clients may formulate policies. The client may be served to a greater degree if the staff is trained to interpret the financial statements and figures obtained from the audit.

Some of the services thus rendered could be a change of bookkeeping system, or suggestions for saving of operating expenses, or an explanation of the reasons for unusual variations in costs, and recommendations for the corrections thereof, or even short-cuts in office procedures. These are the services a client will appreciate and from which he will benefit.

This, therefore, necessitates a constant vigilance on the part of the principal. It is necessary that he review the work papers constantly and discuss questions which may arise from the staff. It is also advantageous for the principal to make periodic visits to the client's office, while the staff members are performing their duties. This constant supervision and vigilance of the staff will certainly be of material assistance to the practitioner and to the client.

Staff Supervision

The staff, naturally, requires constant supervision, and because of its size, the principal must take this added duty on to himself. Supervision is considerably more difficult in the small firm than in a large firm. All members of the staff must eventually become proficient in the handling of all types of auditing assign-

ments, preparation of various types of reports, preparation of federal and state tax returns and forms, and so on.

The small accounting firm cannot adopt a policy of specialization, but rather must develop the capabilities of each member of the staff. An important factor in the efficiency with which a public accounting office is operated is the assignment of the jobs to the men on a basis which will tend to eliminate non-productive time of the staff. This calls for a careful, well-thought-out plan of assignment of the various jobs.

The availability of a man for a particular job is, of course, a factor to be considered. (It will not always be possible to organize the work in such a fashion that non-productive time can be eliminated.) An effort should be made to rotate assignments, so that not only the well-seasoned senior, but the beginner, as well, will eventually acquire the knowledge of the client's work. In this way, when the pressure of work is heavy, any of the men will be in a position to care for the assignment. From an auditing point of view, this is a healthy situation because conditions arising at the clients' offices will create and spur on discussions among the men who have handled and know the job. Invariably, the practitioner will act as moderator in these discussions.

Audit programmes require periodic review and revision. Here again suggestions and recommendations by all members performing work for any particular client will be of great assistance in a discussion and possible revision or additions to the audit programme.

Value of Staff Meetings

Frequent staff meetings serve useful purposes. All members of the staff should attend and be encouraged to voice their views openly. Meetings should always be held on the employer's time, rather than on the employee's time, so that his attendance at the meetings will not conflict with any of his outside interests. The basis for discussions, of course, will be the technical and practical problems of a client. When these discussions take place, the work papers of the client should be referred to constantly. If any decisions are made, or changes contemplated, appropriate notes will be made and be referred to on the occasion of the next visit to, or discussion of that particular client. The benefits derived by everyone from these meetings are numerous.

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There is a certain amount of self-reliance and assurance developed in the members of the staff when someone else shares their opinions. Reports and services to the client are improved. Exchange of ideas and opinions will always prevail at an open and informal discussion, particularly if these meetings are held frequently.

The degree of success of any firm depends on the loyalty of its staff. Loyalty to a firm is a necessity. There should be a community interest of all members of the staff to maintain its public reputation and the integrity of the entire profession. There must be developed in staff members a high degree of loyalty to the profession and to the firm with which they are associated. It is advantageous for the principal to develop this loyalty; for, without it, the quality of the work and his attitude towards clients and others will suffer.

The Right Spirit

A spirit of friendliness, helpfulness, and cooperation should always be present. It becomes necessary, therefore, for the development of a warm employee-employer relationship, in order that staff members may feel a sense of loyalty and belonging to the firm. This cannot be accomplished, however, without adequate compensation to all members of the accounting firm's staff.

Invariably, many young men and women seeking a career in public accounting have the ambition at some time to be a principal. In their early years they may choose between associating themselves with an established accounting firm or eventually building their own practice. Therefore, the subject of compensation is an important one.

Staff members of a small accounting firm are usually paid on a flat weekly basis with additional compensation for overtime. Other firms will institute an incentive plan, whereby members of the staff may participate in the fees of a client on a percentage basis. Still, other firms will, in addition to a weekly salary, pay bonuses, based on a job well done, or a special or difficult assignment. Most offices will also consider additional compensation to staff members, such as Christmas and year-end bonuses, vacations with pay, sick leave with pay, and other considerations. Remuneration on a fair and equitable basis will tend to keep a man satisfied with the association he has made in the accounting firm.

With a well-rounded programme, efficiency of operation, and consideration of staff personnel, staff problems of the small accounting firm may be minimized to a point where they need never exist.

1950 CANADA YEAR BOOK

The Dominion Bureau of Statistics announces that the 1950 edition of the Canada Year Book is now obtainable from the King's Printer, Ottawa, at the price of $2 per copy, cloth bound. Paper-bound copies can be purchased for $1 by *bona fide* teachers, university students, and ministers of religion by application to the Dominion Statistician, Dominion Bureau of Statistics, Ottawa.

The Role of The Small Practitioner

By H. R. Sanders, C.A.

The small practitioner deals with a wide variety of clients and exerts a corresponding influence on the public's concept of the accountant

IN many ways the smaller firms of practising chartered accountants bear a greater responsibility in acquainting the public with the accounting profession than do the larger firms. It is not uncommon for a small office to service 200 or 300 clients during a year. Some larger firms of chartered accountants, on the other hand, may have a clientele made up entirely of a score of the largest Canadian companies and the man on the street does not often get to meet, or even see, the auditors who report upon the financial affairs of these corporations. But for the smaller firms of chartered accountants, our profession would probably be considered by most of our fellow-citizens as a remote body of financial wizards using what skills we possess exclusively on behalf of large corporations.

The smaller practitioner, however, performs accounting and auditing services for the manufacturer, the merchants and members of other professions and organizations. This type of client, in numbers at least, represents a substantial section of the community. Those, therefore, engaged in this type of practice, help formulate public impressions of chartered accountants to a much greater degree than they themselves probably realize.

Ingenuity and Versatility

The accountant servicing small business has to display as much, if not more, ingenuity and versatility than that required during the performance of an annual statutory audit.

The auditor in the first situation must often assume the various roles of accountant, auditor, tax consultant, credit manager, office personnel director, administrator, and efficiency expert. He must possess a good working knowledge of the various Acts and Regulations concerning unemployment insurance, sales tax, workmen's compensation, and personal income tax, some of which are probably considered unimportant in the day-to-day work of larger firms. Very often simple accounting systems are required for new businesses operating on a narrow budget. This probably means that one of the proprietors or shareholders will maintain responsibility for the books and records until the firm is in a financial position to engage office staff.

Some of the short-cut methods which can be used are described below.

Elimination of Accounts Receivable and Payable Ledgers

Sales invoices are numbered and printed in triplicate. The second copy is transferred to an unpaid file. The third copy is filed in numerical order and entered in the sales journal only. As the customer pays the invoice, details of payment are written across the face of the second copy which is then transferred to a customers' paid invoice file. Adjustments for discounts, contra accounts, etc. are made monthly by the accountant and prepared by the client. A list of unpaid invoices is taken off monthly and balanced with the general ledger control account.

Customers' payments are deposited regularly. Providing that deposits representing loans, miscellaneous receipts, etc. are segregated, it is possible to total the remaining deposits on the bank statement and make one entry each month debiting bank and crediting accounts receivable control.

After the volume of business has grown and office staff has been engaged, it is generally necessary to revert to a subsidiary ledger system. In this case, time-saving methods such as posting to the subsidiary ledger from bank advice slips can be employed. The total of the advice slip which records customers' draft collections is then entered in the cash book.

Purchase invoices are first inserted in an unpaid file. When paid, details of payment are also written across the face and transferred to a paid bills file by the proprietor. A list of unpaid bills is taken off monthly by the accountant.

This procedure can be easily followed by untrained people and saves considerable time as numerous postings are eliminated.

Retail Store Records

A simple method of recording retail store sales is employed by instructing the proprietor to deposit all sales proceeds intact, daily if possible. The deposits are totalled from the bank statements and one entry is made each month debiting bank and crediting sales. Again, care must be exercised to segregate deposits representing miscellaneous receipts, bank loans, etc. from other deposits. Consultation with the proprietor and an examination of deposit slips and bank statements is all that should be necessary to obtain this information.

A store fund of an appropriate amount is withdrawn from the bank and is maintained on the imprest fund system. Cash disbursements are made from this fund only, which is restored to the original amount whenever required by issuing a cheque to cash for the total of the vouchers. These are then inserted in an envelope, the classification of expenditures is summarized on the outside and the number of the cash cheque is also written across the envelope. The proprietor is also instructed to write the classification of expenditures on the cheque stub which assists the accountant when he writes up the cheque disbursement journal.

Petty Cash Disbursements in Manufacturing and Trading Concerns

Bills paid by cash over a period of months are first sorted according to classification of expenditure.

Each group is then "run off" on an adding machine; the tape is stapled to the vouchers and an entry on one line in the journal is all that is required to record these disbursements.

Labour Productivity Control

In reviewing the manufacturing operations of a client, it was found that labour costs exceeded the industry average which was 17% of sales. To assist him in eliminating inefficient labour opera-

tions, the accountant instructed him to value total weekly production at selling price which he was able to do easily, and to calculate his total factory production wages as a percentage of the first figure. He was quite pleased to learn that it was not necessary to install an elaborate cost accounting system in order to give him the required weekly control.

An Intimate Relationship

Auditors in a small practice find that clients depend upon them for advice upon many matters outside the accounting sphere. These clients often develop such faith in their auditors that they have called them in to express an opinion on construction plans prepared by their own architects!

This intimate relationship presents many amusing situations. One enterprising client suggested that I write off some of *his* accounts payable as bad debts as he had heard that these were deductible for tax purposes. Another client who was quite interested in the books proudly advised that he had at long last solved the mysteries of debits and credits. Triumphantly, he exclaimed that he could always tell a debit as "they were closest to the office window". I hurriedly dispelled this "theory", lest he move to another building which might face in a different direction.

Because many small businesses are formed with limited capital, all overhead expenses are generally pared to the bone. It is the alert accountant who will examine expenditures to determine whether all are in keeping with the financial resources of the business and absolutely necessary under any circumstances. This brings us to a special overhead item of direct interest to both the accountant and the client, namely the accounting fee.

In these circumstances, accounting fees are generally limited by ability to pay on the part of the infant business swaddling in the midst of unplenty. The accountant must, therefore, devise an efficient system at a fee which is fair to both the client and himself. Under no circumstances should the practitioner servicing this type of client render accounting work at less than the *per diem* fee charged to larger clients. It follows that he must plan his work to give his client the essentials in the shortest number of days at his standard *per diem* rate. The approach should provide good accounting service at a fee within the clients reach. As somewhat demonstrated above, the accountant is called upon to utilize his organizing ability and imagination in order to carry on this type of practice. As much as possible he should accept the assistance provided by adding machines, cash registers, banks, the client's staff, and the client himself to help him keep the records of the enterprise.

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Technical Reading

The chartered accountant engaged in any type of public practice is compelled to do a certain minimum of technical reading and study. If the practitioner is prepared to plan and *execute* a comprehensive study programme covering problems encountered in his particular field, the results in professional work rendered to his clientele and in his personal development can be most gratifying.

In this regard the firm to which I belong has subscribed to a number of periodicals in addition to *The Canadian Chartered Accountant,* some of which are *The Journal of Accountancy,* a weekly financial newspaper (Canadian), various trade publications and the monthly letters published by two of the Canadian chartered banks. Although some of these periodicals rarely deal directly with small business matters, general material on business and economics trends is presented which is of inestimable value to all practitioners, large or small. Excellent material on small business is available from the Dominion Bureau of Statistics and from the Small Business Division of the United States Department of Commerce in Washington.

Developing the Profession

During the fall and early winter months we formed a study group of two chartered accountants and two lawyers, in order to review the new *Income Tax Act.* The accountants learned much from the views advanced by the lawyers, who in turn advised that they too had obtained a clearer understanding of the Act.

All chartered accountants, whether associated with large or small firms, or in government or industry, have an important role to play in helping our profession to grow and develop. As Mr. Douglas D. Irwin, C.A., has pointed out in his article "The Accountant in the Welfare State" (*The Canadian Chartered Accountant,* April 1950), the profession must continuously adapt itself to the changes in our social and economic climate. If the profession is to continue to be held in high esteem by the public, accountants must serve all sections of the community who require their services, without bias. Our fellow-citizens should feel that chartered accountants, like medical men or members of the legal profession, are ready to assist them when required, regardless of the size or type of enterprise with which they are associated, be it a trade union, a church or a large holding company.

In the development of new fields and opportunities, the small practitioner, if he chooses to, can point the way and thereby contribute to the prestige of his profession and to the welfare of the community.

Values of Standing Timber In Forest Fire Insurance

By W. G. Wright

Values of standing timber vary widely. What considerations enter into the determination?

DURING the past few years a good deal of work has been done towards developing some means for insuring standing timber against forest fire loss. Enquiries in Canada and the United States show that this insurance cannot be obtained from the companies underwriting fire insurance at the present time except perhaps for small areas at high cost, and that if limitholders are to have the protection of this insurance at reasonable cost it must be through some form of mutual insurance.

One of the important questions it has been necessary to look into in connection with this insurance is the question of values of standing timber and the financial losses the limitholder suffers where standing timber held by him is killed by forest fire.

This question has now been studied in considerable detail for conditions in the pulp and paper and sawmill industries in Eastern Canada. As far as I can ascertain, the values and financial losses which must be taken into account in insuring standing timber against forest fire loss are not provided for in present accounting practice and it may be indeed that there is no need for this. However, I am venturing to present these notes on the principles that have been considered in determining the values of standing timber and the financial losses that should be covered by insurance, in the hope that these may be of interest to those concerned with the financial problems involved in operating a lumber or pulp and paper company, and at the same time show the purpose of insuring standing timber and the benefits to be derived therefrom.

Wide Variations in Value

Values of standing timber vary widely according to conditions, and for purposes of forest fire insurance insured value must be determined separately for each tract of timberlands and perhaps for different parts of the same tract. The intention in this insurance, as in any other insurance, is that the insured value should not exceed the insurable interest of the insured and this feature must be taken into account in any consideration of insured values of standing timber.

The following are the values and financial losses to be taken into account:

(a) Cost of purchasing new limits to replace standing timber that is fire killed and not salvaged;

(b) Costs of development works that

must be written off against a smaller quantity of wood due to fire-killed wood not being salvaged;

(c) Added costs of wood at the mill for wood cut in replacement of the standing timber fire-killed and not salvaged;

(d) Added costs due to logging and manufacuring fire-killed wood instead of green wood.

In regard to cost of replacing standing timber not salvaged, purchase price can be used as the value to be insured where the timber limits in question have just been purchased and where equally favourable areas can be purchased at the same price. However, these conditions are not typical where forest fire insurance comes to be considered, and the various values and financial losses mentioned above are discussed in detail below for conditions where the timber limits in question were purchased some time ago and where purchase price can hardly be used as value for insurance purposes at this time.

For purposes of this discussion, let us suppose a sawmill operator now holds cutting rights on 100 square miles of timber limits purchased 10 years ago and that a mill was built then to manufacture timber from these areas, and suppose also the merchantable area now consists of:

> Tract *A*, 25 square miles containing 50,000 M f.b.m.[1] close to the mill and opened up for logging.
>
> Tract *B*, 50 square miles containing 100,000 M f.b.m. but 50 miles from the mill, not opened up for logging and to be cut when Tract *A* is exhausted.

Let us suppose also that if part of the standing timber on either of these tracts is fire-killed and cannot be salvaged, the operator can purchase additional cutting rights at a reasonable price to replace the wood lost.

Taking Tract *A* first, we will suppose that 25,000 M f.b.m. out of a total of 50,000 M f.b.m. is fire-killed and that of this quantity 10,000 M f.b.m. can be salvaged and 15,000 M f.b.m. cannot be salvaged and is lost.

The financial losses to the operator under the above conditions are as follows:

1. *Cost of purchasing new limits*:

If cutting rights on new timber limits can be purchased for $2 per M f.b.m. in a location where the sawmill operator can extract the wood economically, then $2 per M f.b.m. is the loss to the operator under this heading, and for the 15,000 M f.b.m. fire-killed and not salvaged the operator's loss is $30,000.

2. *Development costs*:

The operator has created additional values in the standing timber by building roads, dams and other improvements to log economically; if the cost of that part of these works that cannot be used for any other purpose than for extracting the 50,000 M f.b.m. on Tract *A* totals $50,000, then the operator's loss is at the rate of $1 per M f.b.m. and, on the 15,000 M f.b.m. not salvaged, is $15,000.

3. *Added costs of wood at mill*:

With 15,000 M f.b.m. fire-killed and not salvaged, the operator must, if he is to replace this wood, sooner or later cut 15,000 M f.b.m. on Tract *B*, or on the new limits in the event of new limits being purchased. For purposes of this illustration, let us assume new limits are purchased at once and that the operator cuts on these new limits to replace the 15,000 M f.b.m. not salvaged; also, that the cost of wood at the mill from these new limits is $2 per M f.b.m. higher than the cost of wood from Tract *A*.

[1] In this article the term "thousand feet board measure" is shortened to "M f.b.m."

Under these conditions the loss to the operator under this heading on the 15,000 M f.b.m. fire-killed and not salvaged is $30,000.

4. *Added costs for salvaging fire-killed wood*:

These added costs are due to higher logging costs and higher manufacturing costs. Assuming for purposes of illustration that these added costs are $2 per M f.b.m., then the loss to the operator on account of salvaging 10,000 M f.b.m. is $20,000.

The above are the financial losses to the sawmill operator under the conditions described. However, some of these losses may not materialize for some years or may be spread over a number of years; and, since the indemnity to be paid in the event of the standing timber being insured would be paid in the year the timber is fire-killed, even though the financial loss to the operator does not all materialize in that year, it may be necessary for purposes of insurance to discount this loss to some lower figure. This is discussed below under the same headings as before.

1. *Cost of purchasing new limits*:

If standing timber is insured, the insured value will be based upon the price at which new limits can be purchased, and no question of discounting the loss arises here.

2. *Development costs*:

It is reasonable to consider that the financial loss to the operator here will materialize when money is spent on the development constructed for the purpose of extracting the wood to replace the wood lost. If this is to be only in say five years, then some discounting of the $1 per M f.b.m. under this heading in order to arrive at the value to be insured is appropriate. However, if the operator intends that, in the event of Tract *A* being fire-killed, the new area of timber limits will be developed for logging operations as soon as it is purchased, no discounting is necessary.

Mr. W. G. Wright is a member of the Association of Forest Engineers of the Province of Quebec. He is familiar with all parts of Canada from the Maritimes to British Columbia and has studied forestry in Europe. He was connected for over 20 years with Price Bros. & Co. Ltd. and is now a consulting forest engineer in Quebec City.

3. *Added costs of wood at mill*:

This loss, in the illustration, is due to 15,000 M f.b.m. being replaced by an equal quantity of wood on the new timber limits to be purchased. With an annual cut of 3,000 M f.b.m., the 15,000 M f.b.m. to which this loss applies will be cut over a five-year period and it is reasonable to consider that the loss to the operator of $2 per M f.b.m. should be discounted to some lower figure; and the operator may consider that in respect to this loss he is sufficiently protected by insuring the standing timber for $1.50 per M f.b.m.

4. *Added costs for salvaging fire-killed wood*:

It is assumed for purposes of this illustration that the salvage is for sawlogs and that it takes place in the first year after the timber is fire-killed; and for these conditions there is no question of discounting the loss.

So that to summarize for Tract *A*, the financial losses against which the operator would wish to protect himself by insuring the standing timber are as follows:

	Per M f.b.m.
(a) For standing timber to be salvaged—	
Added costs due to salvage	$2.00
(b) For standing timber not salvaged—	
Cost of purchasing new limits	$2.00
Development cost	1.00
Added cost of wood at mill	1.50
	$4.50

If it is expected that, in the event of standing timber being fire-killed, up to 10,000 M f.b.m. will be salvaged and any standing timber over this quantity cannot be salvaged, the insured value for Tract *A* would be as follows:—

	Insured Value Per M f.b.m.	Total
10,000 M f.b.m. salvaged	$2.00	$ 20,000
40,000 M f.b.m. salvaged	4.50	180,000
Average and total insured value for Tract *A*	$4.00	$200,000

For Tract *B* the principles are the same. For purposes of illustration let us assume that instead of part of Tract *A* being fire-killed, 25,000 M f.b.m. is fire-killed on Tract *B* and that, of this quantity, 10,000 M f.b.m. can be salvaged. The financial losses are discussed below under the same headings as before.

1. *Cost of purchasing new limits*:

If, as for Tract *A*, new timber limits can be purchased in a suitable locality for $2 per M f.b.m., then the loss to the operator under this heading would be the same as for Tract *A*, viz., $2 per M f.b.m.

2. *Development costs*:

Since Tract *B* is not opened up for logging, there is no financial loss due to development costs being written off over a smaller quantity of wood.

3. *Added costs of wood at the mill*:

This would be due to replacing fire-killed wood not salvaged by wood from the new limits purchased. And if, for illustration, we assume that the cost of wood at the mill from Tract *B* and the cost of wood at the mill from the new areas purchased are about the same, there is no financial loss to the operator on Tract *B* under this heading.

4. *Added costs for salvaging fire-killed wood*:

The same added costs for logging and manufacturing occur here as for Tract *A*. In addition, roads, dams and other improvements must be built in order to open up Tract *B* for logging, and there is a loss due to higher cost wood on Tract *B* being cut some years earlier than if the wood had not been fire-killed. These last named losses are smaller and the operator may consider he is sufficiently protected against financial loss under this heading by insuring standing timber on Tract *B* at the same rate as for Tract *A*, viz., $2.00 per M f.b.m.

Following the same procedure as in summary for Tract *A*, the financial losses on Tract *B* against which the operator would wish to protect himself by insuring standing timber are as follows:

	Per M f.b.m.
(a) For standing timber to be salvaged —	
Added costs due to salvage	$2.00
(b) For standing timber not salvaged—	
Cost of purchasing new limits	$2.00
Development cost	—
Added cost of wood at mill	—
	$2.00

If, as for Tract *A*, it is expected that up to 10,000 M f.b.m. will be salvaged

and that any standing timber over this quantity cannot be salvaged, the insured value for Tract *B* will be as follows:

	Insured Value	
	Per M f.b.m.	Total
10,000 M f.b.m. salvaged	$2.00	$ 20,000
90,000 M f.b.m. not salvaged	2.00	180,000
Average and total insured value for Tract *B*	$2.00	$200,000

So that for Tracts *A* and *B*, the insured value would be calculated as follows:

	Area Sq. Mi.	Standing Timber M f.b.m.	Insured per f.b.m.	Value Total
A....	25	50,000	$4	$200,000
B....	50	100,000	$2	$200,000
	75	150,000		$400,000

The above illustration is for conditions that might be met with by a sawmill operator cutting 3,000 or 4,000 M f.b.m. a year. For smaller operations and for larger operations, the principles are the same although the application of these may differ. For example, for a pulp and paper company with say 3,000 square miles of timber limits and an annual cut of 250,000 cords of pulpwood, the company might consider that it has sufficient areas of timber limits in reserve to do away with the need for purchasing additional timber limits to replace any standing timber that is fire-killed and cannot be salvaged, and so may not need insurance of standing timber to protect itself against that part of its financial loss represented by the loss involved in purchasing new timber limits. Also, where pulpwood is fire-killed a larger proportion of fire-killed wood can generally be salvaged and such salvage operations might be spread over a number of years. Below is an illustration of the way in which the above principles might be applied for these conditions:

	Square Miles
Total area	3,000
20% reserve included in this total	600

INSURED VALUES FOR THE MERCHANTABLE AREA

	Area Sq. mi.	Quantity of standing timber cords	Insured Value Per cord	Total
Tract *C* opened up for logging	200	1,000,000	60 cents	$ 600,000
Tract *D* opened up for logging	200	1,000,000	50 cents	500,000
Tract *E* not opened up for logging	1,100	5,500,000	—	—
	1,500	7,500,000	—	$1,100,000

The insured values above noted for Tracts *C* and *D* cover financial losses in respect to salvage, development costs, and added costs of wood at the mill as detailed in the illustration for sawmill operations, financial loss in respect to purchasing new timber limits not being needed since the 600 square miles reserve area is provided to cover this loss. For Tract *E*, under the conditions assumed for this illustration, there is no loss in respect to development costs or added costs of wood at the mill and, as for Tracts *C* and *D*, no loss in respect to purchasing new timber limits; and, since the purpose of the insurance would be to protect the limitholder against the minimum financial loss he suffers, there would be no insurance taken up to cover the loss involved in added costs of salvage.

As these illustrations show, the financial losses against which the sawmill operator, the pulp and paper company or other limitholder would wish to be protected by insurance of standing timber may vary greatly from place to place and from year to year, and the insured value for the standing timber must be estimated for each tract of timber or for different parts of the same tract according to conditions.

The same principles apply in considering values of freehold land or of young growth for purposes of forest fire insurance, though for young growth these values must be low; and they apply if standing timber fire-killed and not salvaged is replaced by logs or pulpwood purchased from some other operator.

The principles discussed above can be applied for other purposes than that of forest fire insurance. For example, a breakdown of the values as above detailed should be useful in any purchase or exchange of timber limits and would emphasize the great variation in value between timber limits nearer to centres of manufacturing and timber limits in the more remote regions; also, there is good reason to consider taking into account variations in value that exist for different parts of the same tract of timber limits when calculating rate of depletion for income tax purposes.

Stock-in-Trade And the Auditor

By Garfield G. Goult, F.C.A.

The third part of Mr. Goult's treatise: the first and second parts appeared in preceding issues

IV. THE AUDITOR'S PROCEDURE

73. Having dealt in the two preceding sections with the accounting treatment of stock-in-trade and the auditor's responsibility, it now remains to consider the auditor's procedure. Owing to the wide variety of circumstances affecting stock-in-trade, it must be left to the judgment of the auditor to decide on his audit procedure in each particular case. His enquiries should be directed towards satisfying himself that he has been presented with an inventory which has been carefully and properly prepared and the result of his enquiries will determine the extent to which tests can usefully be applied. At the risk of including some of the more elementary points it has been thought desirable to make this section reasonably comprehensive, but it does not purport to form an audit programme. The matter has been approached under four heads:

(a) Accuracy of the records.
(b) Method of valuation.
(c) Existence of the stock-in-trade.
(d) Balance sheet description.

In each case attention has been drawn to certain points involved not all of which are necessarily applicable in any particular case. The third head, that is the question of the existence of the stock-in-trade, is one on which the opinion of the profession is far from unanimous in regard to audit procedure.

Accuracy of the Records

Internal Control

74. In considering whether the records presented to him are accurate the auditor is concerned with two possibilities: (a) clerical errors; (b) fraud; and in both cases his procedure will be governed by the extent to which the system guards against such possibilities. Different considerations apply in regard to errors and fraud respectively, but in both cases the important principle is that the internal control system should not permit any one person to carry sole responsibility for any section of the work. Auditing separately the acquisition and disposal of goods is comparatively simple; the difficulties arise in ensuring that there is an adequate link between acquisition and disposal, thus showing the stock-in-trade remaining on hand. The accounting treatment has been considered in Section II and the principles there stated should be borne in mind in considering the efficacy of the internal control system.

An address delivered at Oxford in July, 1949 and published in *The Accountant*, August 13, 1949

75. The auditor may find that no internal check or control is in operation; or he may find a highly organised internal audit or internal control department. The essential features of stock recording are stated in paragraph 8 (to which reference should be made) and it is for the auditor to consider:

(a) To what extent the system provides *in principle* an effective check at every stage of recording. This he can do only by applying his experience and judgment to ascertain the possible ways in which the system could be avoided or could fail to bring to light an error.

(b) To what extent the system laid down is *in practice* duly followed. This he can do by careful examination of the records for the signatures of persons responsible for them and by observing the actual operation of the system.

After consideration in this way the auditor will be in a position to decide on the extent to which he needs to apply the detailed checks and tests referred to in the succeeding paragraphs. His conclusions may suggest improvements in the system which if adopted will be to his own as well as to his client's benefit.

76. In large organisations operating several factories run as branches or as subsidiary companies, the chief accountant carries the responsibility of satisfying the board as to the accuracy of the stock-in-trade figures. He is in much the same position as an auditor in that he must rely on the staff, but he has better opportunities and greater technical knowledge of the business to enable him to be satisfied that the procedure he has laid down is carried out. The growth of industry and the development of industrial accounting have resulted in the introduction of carefully planned stock-recording procedures, and there is every advantage to be gained from consultation between the client or his chief accountant and the auditor. Such consultation will enable the auditor to bring to bear his experience of other businesses and will also enable him to appreciate more readily the practical difficulties to be overcome.

Clerical Errors

77. The following are points requiring attention where no perpetual inventory is maintained, so that an inventory prepared at the year-end forms the basis of the accounts (or where a perpetual inventory is maintained but is not controlled by the financial accounts):

78. (a) The link between purchase records and inventory:

(i) Invoices must be put through the books for all items taken into the inventory;

(ii) Conversely, the inventory must include goods in transit for which the invoices have been charged;

(iii) It may be necessary, where substantial quantities are involved, to obtain suppliers' confirmation if invoicing is delayed;

(iv) Goods which are not owned but are on consignment from others must be excluded from the inventory.

79. (b) The link between sales records and stock records:

Goods sold but still on the premises must be excluded from the inventory if the property has passed and the sale has been charged.

80. (c) The nature of the items in the inventory:

(i) Loose tools, machinery, equipment or other items which have been dealt with as fixed assets must not be taken into the inventory.

(*Note*: Loose tools may frequently be inventoried for valuation purposes but this is a separate matter);

(ii) A comparison with the previous inventory will disclose any material

variations which require satisfactory explanations;

(iii) Unless items are adequately and clearly described, errors will arise in valuations;

(iv) Stores charged to nominal accounts other than trading purchases require correct allocation to those accounts.

81. (d) The use of subsidiary and uncontrolled records in compiling the inventory:

(i) Rough stock sheets require comparison with the final inventory.

(ii) Where independent stock records are kept for costing or stores control they should be in agreement with the inventory.

82. (e) The dates on which the inventory was taken:

(i) Where, as may frequently be the case, stock-taking has been spread over several days, adjustments may be necessary in respect of matters referred to under (a) and (b);

(ii) Movement of stock-in-trade from one place to another during the stock-taking period may result in either omission of an item or its inclusion twice.

83. The following points require attention where the stock records form a controlled part of the accounting system.

84. (a) The extent to which a physical check has been imposed on the stock records:

(i) The records should in all cases indicate clearly the persons responsible, the dates on which the checking took place and the degree of accuracy found;

(ii) In cases where the procedure involves a continuous check throughout the year, the whole stock-in-trade should be covered and the danger of the procedure not being faithfully carried out needs consideration.

85. (b) Where the stock records show values as well as quantities, the nature of the value entries requires scrutiny if these are used for the purpose of inventory. It may, for example, be the practice to maintain records for conveniences in selling prices or at standard prices.

86. The following points require consideration irrespective of the method of arriving at the stock-in-trade figure:

87. (a) The arithmetical accuracy of of the inventory; casts and calculations require checking or testing.

88. (b) Certification of the inventory:

(i) All persons responsible for taking stock, pricing, calculations and casts should sign. The persons doing so should be in accordance with a list containing specimen signatures and approved by a responsible official;

(ii) The inventory as a whole should be certified by a responsible official and approved by the managing director. (See also paragraph 124.)

89. (c) The personnel engaged on stock-taking:

(i) Persons actually handling the goods, who will in general be found to have some degree of pride in their work, are more likely to produce a correct count under accurate descriptions, than persons specially assigned to the task;

(ii) On the other hand the supervision of the count or its control from other records, must be adequate, otherwise the internal control is weakened.

90. (d) The availability of statistical records from which consumption can be tested:

This is particularly important in regard to bulk stocks which are subject to wastage in making-up, or

stocks subject to loss by evaporation, or stocks which change their form in the course of processing.

91. (e) Record tickets:
Where stock-in-trade and particularly work in progress is identified by tickets attached to the articles these will form a useful means of compiling an inventory (or verifying costing records) and the auditor may find these a convenient method of tracing forward to the date of the audit.

Fraud

92. Since the treatment of stock-in-trade is one of the most difficult of accounting matters and one to which too little attention is often paid, it forms a suitable medium for fraud. The auditor must bear in mind the possible directions in which fraud may exist:

93. (a) By directors against the interests of the company, which may take the form of manipulation of the inventory so as to affect the trading results;

94. (b) By employees against the interests of their employers; for example, misappropriation of goods, or manipulation of records by a manager whose remuneration depends on profits or who may for other reasons wish to show a more favourable result for his branch or department;

95. (c) By a partner against his copartners, which may take the form of misappropriation or of manipulation with a view to affecting his share of profits;

96. (d) By sole proprietors, partners or directors, for various purposes such as income-tax evasion or the bolstering up of a business for sale or with a view to obtaining credit, in which cases manipulation of the inventory may be a suitable medium.

97. The auditor must consider who are the persons who might be interested in manipulation or who are most likely to have opportunities for misappropriation. It is then necessary to decide whether the control system is adequate to guard against the possibilities. One of the most important considerations is whether the person responsible for the stock-taking procedure and for the valuation is a person who might be interested in manipulation or might be influenced by such a person. If that possibility exists the procedure calls for the closest scrutiny and the auditor may feel it necessary to insist on appropriate changes being made.

Method of Valuation

98. The principles involved in valuing stock-in-trade have been considered in Section II. It is generally accepted that the basis should be the lower of cost or market value and this has been endorsed by the Council in recommendation No. X. The auditor would need exceptional reasons to be submitted in support of the adoption of any other basis. The auditor's procedure will be directed to the following:

(a) The method of calculating cost;
(b) Provision against loss;
(c) The possibility of manipulation;

The first two matters are considered separately in the succeeding paragraphs. With regard to the possibility of manipulation it need only be said that the considerations just mentioned in relation to fraud apply particularly to the valuation. The auditor normally has not the technical knowledge to detect skilful manipulation; he must rely largely on the system of internal control, on his testing of the operation of that system and on his own assessment of the persons likely to be interested in manipulation.

Method of Calculating Cost

99. In Section II the main methods in use for calculating cost have been given and, as stated there, no particular basis

is suitable for all types of business. It will be for the auditor to consider whether that adopted by his client is a reasonable method having regard to the particular circumstances. He must bear in mind that on the one hand the profit and loss account must show a true and fair view of the results of the year; whilst on the other hand the balance sheet must show a true and fair view of the state of affairs. In some circumstances the basis used may cause difficulty in reconciling these two requirements. For example:

100. (a) The "base stock" method carries advantages of convenience and in some industries long usage, but its effect on the balance sheet or the annual results will be to produce distortion where the actual prices and/or quantities handled have varied considerably. If there has been little variation in quantities held at the beginning and end of the year this method, adopted consistently, may not materially distort the results of the year. But if the value at which the base quantity is taken is greatly below current costs the auditor must consider whether for balance sheet purposes the discrepancy constitutes a reserve; conversely, if current costs are lower, it will involve the over-valuation of a current asset. The "base stock" method amounts almost to treating the base quantity as a fixed asset, but this is a view of convenience only and is not borne out by the facts — the base quantity is not "fixed" but is held for conversion into cash and is not subject to depreciation provisions.

101. (b) The "last in, first out" (LIFO) method, which has been adopted on a wide scale in America and has been recognised there for taxation purposes, calls for careful scrutiny in the circumstances in which it is used. (It is not possible to say yet whether its adoption in America will be sustained.) Where stock-in-trade is turned over rapidly no special points arise, but where considerable stocks of slow-moving goods are held the balance sheet position may become difficult. In the profit and loss account the effect is to charge against revenue the latest cost and there are reasonable arguments in favour of regarding this as a true and fair view. But if the result is that in the balance sheet stock-in-trade recently purchased appears at a cost substantially below actual cost, the question again arises of whether the difference does not constitute a reserve.

102. (c) Similar considerations would apply to the "average" method if the effect is to produce only arithmetical averages bearing little relation to actual cost.

103. (d) "Standard" cost, where standard costing is in operation, will require appropriate adjustments for variances. The auditor should also be satisfied that appropriate revisions of standards are made when necessary. Without a sound knowledge of the principles of standard costing the auditor may easily fail to detect serious shortcomings in the operation of the system.

104. (e) The "adjusted selling price" method lends itself easily to error or manipulation, since it amounts in effect to fixing the profit before arriving at the value of stock-in-trade.

105. The main principle which the auditor should bear in mind in considering the suitability of the method used is that *it is a means of calculating cost* and if the effect is not to approximate to that result, then the accounting procedure has not been satisfactory. Bearing in mind the general objective the following are points requiring the attention of the auditor:

106. (a) The validity of the pricing:

(i) Variations in the pricing of the stock records compared with invoices require explanation;

(ii) Some methods will not enable a direct check with invoices to be imposed; as, for example, the "average" method, where appropriate tests of the calculations must be carried out;

(iii) Comparisons with previous stock-takings will frequently prove a useful method of directing attention to items requiring further enquiry;

(iv) Under the "first in, first out" (FIFO) method care is needed to ensure that the latest price is not used for a greater quantity of stock-in-trade than has been purchased at that price.

107. (b) Allowance for evaporation and similar wastage:

Percentage deductions may be in use to take account of these losses and such percentages require periodical review.

108. (c) Inter-departmental profits:

Whilst internal loadings may be appropriate for departmental purposes, any stocks held at the end of the financial year require adjustment if the stock records include purely internal loadings.

109. (d) Inter-company profits:

Trading between inter-connected companies will necessitate adjustments; for example, to eliminate inter-company profits between subsidiaries or between a parent company and a wholly-owned subsidiary. Transactions between companies having different balance sheet dates require special scrutiny.

110. (e) Direct expense:

Additions to invoice cost may be made for delivery charges, cost of handling into store, and, on imported goods, duties, dock and other charges.

111. (f) Overhead expense:

(i) Where cost is increased by an addition for overhead expense the basis requires careful scrutiny. The use of percentage additions may result in serious distortion of cost through variations in quantity. A calculation of the effect on profit of an error of say 5% in the stock valuation will illustrate the importance of an apparently small error in overhead allocation;

(ii) It should be appreciated that the inclusion of fixed overhead expense has the effect of upholding in the stock valuation expenditure related to time and not to production;

(iii) Overhead expense included in cost accounts may frequently be unsuitable for inclusion in the annual stock-taking, having regard to the purpose (for example, selling price policy) for which the costs have been prepared.

112. (g) Work in progress:

(i) The proper allocation of the cost of raw materials and wages to unfinished work will depend on the costing system in use. If this is done by arbitrary methods instead of by accurate accounting analysis, serious errors may arise;

(ii) Where the practice is to value unfinished work by a deduction from the cost of finished goods representing work still to be done, both the assumed "finished cost" and the basis of deduction require scrutiny. Tests will be required to ensure that the calculation does not produce a figure in excess of cost built up from materials, wages and expenses;

(iii) The taking of profit on long-term uncompleted contracts requires a special scrutiny in the circumstances of each case.

113. (h) By-products:

To ascertain the cost of by-prod-

ucts is usually impossible. Whatever system may be in operation the essential point is to ensure that the cost of the main product is reduced by the amount of any value attributed to by-products.

114. (i) Ratio tests:
Various overall tests may be applied such as gross profit ratio to turnover, or, in the case of some kinds of stock-in-trade, the calculation of turnover by charging up consumption at selling price. It should be understood, however, that such tests are not conclusive since they are based on the assumption that the turnover is properly recorded. Indeed, such tests used in conjunction with reliable stock records may easily be the means of discovering defalcations in other directions.

115. An exception to the foregoing is the special case of a company adopting the practice referred to in paragraph 26, namely, a produce company which follows the custom of valuing stocks of products at the prices subsequently realized less only selling costs. In this case the auditor would direct his attention to the records for the subsequent period to confirm the realization and verify the adequacy of the deduction for selling expenses.

Provision Against Loss

116. It has been emphasized in Section II that any reduction of the stock valuation below cost is a provision against anticipated loss where the net realizable value is less than cost. The calculation of any such provision should not be confused with the ascertainment of cost; it follows as a distinct operation after the stock has been computed at cost. In practice, however, auditors may find that the inventory has been priced at the lower of cost or market value without indicating cost where market value has been taken. In such cases the audit becomes more difficult although there is no alteration of principle. As previously indicated, if the provision is calculated item by item, the stock records may show market value only for those items which have been reduced below cost. Where, however, the provision is calculated in total for the whole stock or for separate categories of stock, which has the effect of offsetting increases in market value against decreases, it becomes necessary to show both cost and market value for each item so that the two aggregates may be compared; except that (as stated in para. 37) the market value may not be shown at all if the nature of the stock is such that it is obvious that the net realizable value is greater than cost, so that no provision is required — this would be the case where stock is not slow-moving and there is no reason to suppose that the company will not continue to operate profitably.

117. The auditor's procedure will be directed towards the validity of the estimated net realizable value, i.e. the amount at which it is estimated the stock can be realized, either in its existing condition or as incorporated in the product normally sold, after allowing for expenditure to be incurred before disposal. For this purpose the following considerations are material:

118. (a) In the case of finished or mainly finished goods, the prices subsequently obtained and the expenditure incurred before disposal.

119. (b) In the case of raw materials and work in progress, the same principle of ultimate realizable value applies; the current replacement cost is not relevant. If the auditor has satisfied himself that the finished goods are below market value, no provision would normally be necessary in respect of raw materials or

work in progress since they will, by ordinary manufacturing processes, become finished goods of the kind on which a decision has already been made; but the position may be otherwise if the prices at which raw materials have been purchased are considerably in excess of the prices paid for materials which have gone into existing finished goods, or if the quantity of materials held is substantially in excess of requirements and there is an actual or prospective fall in selling prices.

120. (c) The quantity held may be so large in relation to turnover that a long-term view of the probable market trend is necessary. Where stock records are maintained those for the larger items will disclose the rate of turnover.

121. (d) Obsolete, damaged or otherwise unmarketable stocks may be included. Scrutiny of stock records and comparisons with previous years will assist in detecting material items of this nature. Special precautions are necessary in the case of seasonal trades and fashion trades such as ladies' clothing; or stocks of a product which has ceased to be manufactured during the year; or unusable advertising material. Similarly a change of design in the main product may result in large stocks of parts being reduced to scrap value.

122. (e) Unsaleable or unusable stocks should be segregated in the records and the loss written off. On stock-in-trade of this kind the loss has already been incurred and the amount thereof should not be amalgamated with the provision for anticipated losses on saleable and usable stocks.

123. (f) Any excessive reduction, not supported by the information available as to realizable value, cannot now be ignored as representing conservative company accounting if the amount is material. Such excess amounts are now required to be treated as reserves.

EXISTENCE OF THE STOCK

124. It is certainly "no part of an auditor's duty to take stock" (as was said in the *Kingston Cotton Mill* case, *supra*) any more than it is his duty to write up the ledger. The primary responsibility for the accounts rests with the directors, on whom penalties are imposed by sec. 149 of the *Companies Act, 1948,* for failure "to take all reasonable steps to secure compliance as respects any accounts laid before the company in general meeting with the provisions of this section and with the other requirements of this Act as to matters to be stated in accounts".

125. Nevertheless, the auditor is required to report on the balance sheet, in which stock-in-trade appears as one of the assets, to the effect that it shows a true and fair view of the state of affairs. The other assets in the balance sheet are all subjected to some form of verification and there is a considerable body of opinion in the profession which takes the view that an auditor who takes no steps to satisfy himself on the existence of the stock-in-trade does so at his own risk. This view has undoubtedly been strengthened by the American case of *McKesson & Robins.* At the same time it must not be assumed that an auditor who does not make any physical test of stock-in-trade has taken no steps to verify its existence. Where an efficient system of internal control is in operation the risk of stock records proving materially false is slight.

126. There is much force in the arguments against any attempt by the auditor to make physical tests. For example, it is true that an auditor could not profess to know whether a given stone in a jeweller's stock is diamond or paste; or whether a fur is of good or bad quality; or the difference between the grades of cloth in a textile concern; or whether a particular liquid is a valuable chemical

or coloured water. It would be quite wrong to give the impression that the auditor is himself capable of taking stock and accepting responsibility for it.

127. The practice of attending to observe the making of physical tests, now adopted by some auditors, should not, however, be discouraged; in fact, this has proved to be useful in many instances. The primary value of such tests in the presence of the auditor lies in the fact that they enable the auditor to be satisfied beyond reasonable doubt that the accounting procedure laid down, including the system of internal control, is in fact faithfully followed in practice. It is far from unknown in the case of a business operating under carefully devised and widely distributed procedure manuals for an employee to observe casually that a particular procedure has not been in use for a long time — a fact of which the chief accountant was entirely unaware. The value of physical tests grows greater as the system of internal control grows weaker; and it is safe to assert that where there is little internal control and the stock-in-trade is not recorded by "perpetual inventory", a physical test is the only means by which the auditor can ultimately assess the credibility of the stock-in-trade figures.

128. As an indication of the way in which such tests may be effected, reference may usefully be made to the following extract relating to inventories from "Extensions of Auditing Procedure" (No. 1 of the statements on auditing procedure issued by the Committee on Auditing Procedure, American Institute of Accountants, October, 1939). In quoting this extract, which now represents an accepted American standard, it may be noted that it is the practice to require United Kingdom auditors of American corporations or subsidiaries to comply with the "Extensions of Auditing Procedure":

129. "(A) That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and enquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation.

In cases where the inventory is determined solely by a means of a physical inventory at the end of the accounting period (or at a date prior or subsequent thereto but within a reasonable time thereof, with adequate records supporting the interim changes), it will ordinarily be necessary for the foregoing procedures to be followed at that time.

In cases where the concern maintains well-kept and controlled perpetual inventory records supported by (1) a complete physical inventory at a date not coincident with the balance sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by the auditor, his purpose being to satisfy himself as to the credibility of the perpetual-inventory records and whether they may be relied upon to sup-

port the inventory totals as shown in the balance sheet.

130. (B) That hereafter, in the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from such custodians is acceptable procedure; except that, where the amount involved represents a significant proportion of the current assets or of the total assets of a concern, the independent certified public accountant shall make supplementary enquiries.

131. It should be clearly understood that in undertaking these auditing procedures regarding inventories, the independent certified public accountant does so for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition and does not hold himself out as a general appraiser, valuer, or expert in materials."

132. The extent, if any, to which physical tests need be carried will be for the auditor to decide having regard to the whole of the considerations already discussed in this paper. It is not thought necessary or advisable that the auditor's report should indicate that such steps have been taken. Such a course is followed under American practice, as shown in the following report of the auditors of an American subsidiary of an English company:

> Merchandise and supplies on hand at December 31, 1947, in the company's plant and warehouses were inventoried by the company's representatives and we tested physically the quantities shown by the inventories and examined stock records. We satisfied ourselves that the company's stock records are efficiently maintained. The inventory was valued at average cost arrived at after deduction of fixed manufacturing expenses.
>
> Market quotations of raw materials on hand indicated a value in excess of the amount at which such materials were carried in the inventory. Forward purchase commitments indicated a value below the cost of replacement at December 31, 1947.

The practice in the United Kingdom of giving a "clean" report unless the auditor finds it necessary to make some qualification seems preferable to any attempt to indicate the scope of the work done during the audit.

Balance Sheet Description

133. It is thought that the balance sheet should indicate the basis on which stock-in-trade has been valued, which will normally be "at cost" or, where a provision has been necessary, "at lower of cost or market value". Where any other basis has been adopted the facts should be made clear; in this connection it should be noted that the Council has recommended that if the value is calculated by reference to replacement cost, it should be described as "at the lower of cost or replacement value", but in no case should it exceed market value, as described in recommendation X (paragraph 31). Apart from the question of valuation, the balance sheet should state the amount of any stock-in-trade which has been hypothecated.

134. It is also thought that if expressions such as "as valued by the directors" or "as certified by the managing director" are used in the balance sheet, they should be accompanied by a statement of the basis used. Such expressions are reminiscent of the *Kingston Cotton Mill* case, *supra,* considered in Section III, and it would seem unwise for an auditor to assume that such wording in the balance sheet would afford him any protection. It is for the auditor to satisfy himself that the balance sheet shows a true and fair view, and, if the audit of the stock-in-trade records has not enabled

him to be so satisfied, his duty is to qualify his report accordingly. These remarks do not imply that the auditor should not attach importance to the terms of the certificate taken from a director having full knowledge of materials and current prices.

Conclusions on Procedure

135. Stock-in-trade takes many diverse forms and it would require many volumes to consider in detail all the auditing questions which might arise throughout industry and commerce. Even in the same company stock-in-trade of various kinds, or in various stages of processing, may often call for different treatment. Having regard to the views put forward in this paper, it is suggested for discussion that, irrespective of the nature of the business, the auditor's procedure should be governed by the following broad considerations:

136. (a) The auditor must endeavour to satisfy himself as to:

(i) The accuracy of the records bearing in mind the requirements of the *Companies Act, 1948,* for the keeping of proper books of account and his duty to report thereon;

(ii) The basis of valuation, including any provision necessary for possible loss and the segregation to reserve of any excessive reduction bearing in mind his duty under the *Companies Act, 1948,* to report whether a true and fair view is shown in both the balance sheet and the profit and loss account.

137. (b) In order to so satisfy himself the auditor must impose such checks as he may judge to be necessary, exercising the care, caution and skill which can reasonably be expected having regard to professional standards generally (see paragraphs 45, 46 and 47).

138. (c) In determining the checks which are necessary the auditor must consider the extent to which error and fraud may be possible and the efficacy of the internal control arrangements designed to avoid those possibilities. In this connection the instructions issued by the client for the taking and valuing of stock-in-trade, particularly where there is no perpetual inventory, are of great importance and require careful examination by the auditor.

139. (d) Generally speaking verification will be more difficult where a physical inventory has had to be made than where physical stock-taking is necessary only as a means of testing the accounting records; but in the latter case a sound appreciation of the accounting and costing system in operation is essential if adequate tests are to be applied.

140. (e) The practice of attending to observe the making of physical tests is commendable and could with advantage be adopted more widely in appropriate cases.

141. (f) Words in the balance sheet indicating the persons accepting responsibility for stock-in-trade should not be regarded by the auditor as offering any protection to himself. It is for the auditor to satisfy himself that the balance sheet shows a true and fair view and if the audit of the stock-in-trade has not enabled him to be so satisfied, his duty is to qualify his report accordingly.

* * * *

142. With the development of cost accounting has come a wider appreciation of the value of stock records but the average trader may continue to think that accounting for stock is complicated and commercially unnecessary. There is nevertheless still a wide field where stock accounting could be introduced with due regard to economy. An auditor who uses his influence and persuasive powers to bring about this desirable state of affairs may find that he has enhanced his

goodwill with his client in addition to increasing his own confidence in the stock-in-trade inventory. Auditing technique must march alongside accounting technique and the purpose of this paper will perhaps have been served if the result is a further application of our thoughts to the importance of the treatment of stock-in-trade in the accounting records.

Recent Books

Basic Cost Accounting, by S. W. Specthrie, M.B.A., C.P.A.; published by Prentice-Hall (Inc.), New York; pp. 294 and index; price $5.00

This book is offered for the use of students wishing to learn the principles, procedures, and executive uses of manufacturing cost accounting. The author indicates in the preface that the manuscript was taught to classes of Roosevelt College School of Commerce in mimeograph form before publication.

The author has accomplished a very useful task in presenting an adequate coverage of his topic within 299 pages (including index). This is a remarkable achievement in a field where most texts run to a length of 500 pages or more. Professor Specthrie has done this by efficient organization of his material, precise and economical use of words, and strict limitation of his discussion to costs of manufacturing. His treatment consistently emphasizes the flexibility of the procedures illustrated in order that they may be adaptable to the peculiar needs of managements of individual businesses.

Professor Specthrie is to be congratulated on production of a work which should prove to be a very practical aid to students and teachers of accounting.

W. G. Leonard, F.C.A.

The Kon-Tiki Expedition, by Thor Heyerdahl; published by Thos. Nelson & Sons Ltd.; pp. 238; price $3.00

We read the British edition of this book before the United States and Canadian book reviewers got their raves into print. These raves are not overdone and we suggest that you prove it for yourselves. It is adventure at its best and well-written too. All men, from 12 years up, will find it fascinating.

R.F.B.T.

Current Reading

Thankfulness

THOSE of us who met, admired, and enjoyed Mr. B. H. Binder, then immediate past president of the Institute of Chartered Accountants in England and Wales, at our annual meeting in Toronto in September 1949 will recall his inimitable and easy manner of speaking. The following paragraph is taken from *The Accountant,* June 17, 1950, and was a part of a short address in which Mr. Binder seconded a vote of thanks to Sir Russell Kettle, who had just finished his year of office as president, —

> In returning thanks one often looks back to see whether somebody may not have expressed what you feel better than you can do yourself, and I find this indicated in a sentence of the Book of Common Prayer. There is a sentence there which says: "Yea, a joyful and pleasant thing it is to be thankful." That implies you have something to be really thankful for, and if it gives you a joyous and pleasant feeling also, I suggest that thankfulness is mixed with admiration for the services that you have received and the benefits that you have derived from it. With that sentiment I cordially second the vote of thanks to Sir Russell Kettle.

Minimum Disclosure

The following advertisement taken from the Stanstead (P.Q.) *Journal* of August 28, 1950, has been sent to us by one of our members with the comment, "I still haven't decided how they stand."

Beebe Athletic Association Inc.

BEEBE, QUE.

FINANCIAL STATEMENT PERIOD ENDING AUGUST 10, 1950

Jan. 1. Unpaid bills:		
	Dawson Co.	$345.84
	George Seguin	58.00
	J. Mayo	206.75
	Three Villages Assn.	21.96
	E. Lacroix	220.27
	Godbout Co.	58.00
	R. Rediker	278.00
	Miscellaneous	115.00
		$1303.82
Total Receipts for Current Year		$2306.55
	(Including Dominion Day Celebration and Donkey Show)	
Total Disbursement		$2071.55

A. Dalziel, Secretary

Report of the 48th Annual Meeting

By Clem L. King, F.C.A.
Secretary, The Dominion Association of Chartered Accountants

THE 48th Annual Meeting of The Dominion Association of Chartered Accountants was held at the Charlottetown Hotel in Charlottetown, P.E.I. from August 21 to August 25, 1950.

The Executive Committee met at Pictou Lodge, Nova Scotia, on Friday and Saturday, August 18 and 19, and in the Charlottetown Hotel on Friday, August 25. Council met in the Charlottetown Hotel on Monday afternoon, August 21, Tuesday morning and afternoon, August 22, and on Friday morning, August 25. The Committee on Education and Examinations met Monday morning and evening, August 21. The Committee on Uniform Regulatory Legislation met on Monday morning, August 21. General sessions were held on Wednesday morning, August 23, and on Thursday morning and afternoon, August 24. The 48th annual general meeting was held on Friday morning, August 25.

The convention was highly successful from all points of view. There were approximately 220 persons registered, including the wives of many members and, in not a few cases, their children, many delegates from Quebec and Ontario taking advantage of the vaunted summer resort merits of the Island to combine their presence at the annual meeting with a family vacation.

The convention had only begun when its smooth course was threatened by the declaration of the railway strike on Tuesday, August 22, which affected all but a few of the employees of the Canadian National Railway's Charlottetown Hotel. From this day until the conclusion of the meeting the hotel was unable to offer most of its usual services beyond the provision of rooms. Delegates registered at the hotel were obliged to take their meals elsewhere, make their own beds, tidy their own rooms, and when spirits demanded, obtain their own ice and other requirements from the remote depths of the hotel. All this was accepted in good grace and indeed contributed no little to the general feeling of camaraderie, which was most noticeable throughout. The host Institute's committee on arrangements, under the efficient direction of chairman R. W. Manning, C.A., although all their plans were thus set at nought, accepted the situation without once losing their ever-present smiles, and had their original plans not been advertised in the programme no one would have known that their execution had been in the least modified as a result of the strike.

The programme arranged by the host Institute was thoroughly enjoyable. The reception at Government House by His Honour the Lieutenant-Governor and the host Institute on the Tuesday evening was followed with an afternoon on the beautiful white sands of Cavendish Beach and in the warm salt water of the Gulf of St. Lawrence or, for the golfers, 18 holes on the famous Green Gables links. In the evening lobster dinners were laid on at four different beach resorts for our mem-

bers, followed by a 25-mile motorcade to the government potato warehouse and a country dance. The following night the Royal Canadian Navy were overwhelmingly hospitable hosts on the after decks of His Majesty's Canadian frigates, *La Hulloise* and *Swansea*. There followed a voyage by ferry boat across Charlottetown Harbour to the opposite shore, a walk along a tree-lined country lane to a bonfire complete with corn and weiners for roasting.

For the ladies a luncheon and bridge by the seashore and a tour of historic Charlottetown were enjoyed while the male delegates (together with two lady accountants) were attending Council, committee, and business sessions and also hearing a most interesting and entertaining luncheon address by Premier Walter Jones of Prince Edward Island, who minced no words in expressing his displeasure with the Dominion Government at not keeping its ferries in service between the mainland and the Island. The convention concluded on the Friday evening with a reception and supper dance at the Charlottetown golf club, which will long remain in the memory of those who were present for the beauty of the night and of the locale.

The first general session of the convention was held on Wednesday morning with Mr. A. E. Beauvais, C.A., of Quebec, second vice-president of the D.A.C.A., in the chair. The subject was Municipal Accounting and Auditing, and the speakers Messrs. C. L. Beazley, K.C., Deputy Provincial Secretary of Nova Scotia, and J. H. Lowther, Chief of Public Finance Statistics, the Dominion Bureau of Statistics.

On Thursday morning a general session on "Taxation of Individuals and Closely-Held Companies" was held under the chairmanship of the immediate past president of the D.A.C.A., Mr. E. J. Howson, F.C.A., of Ontario. The speakers were Messrs. G. P. Keeping, C.A., Montreal, who spoke on the operation of the new Part 1A of the Income Tax Act, H. J. Egan, C.A., Halifax, who spoke on allowance in respect of interest and bad debts, and H. S. Moffet, C.A., Regina, who spoke on problems relating to capital cost allowance regulations. A paper on taxation problems of small businesses by Dr. J. R. Petrie, Professor of Political Science and Economics at the University of New Brunswick, was prepared for delivery at this session, and although the paper was present, Dr. Petrie himself was not. He was caught by the railway strike deep in the hinterland of New Brunswick. This was the only untoward effect of the strike as it affected the convention but Dr. Petrie's paper will be published in *The Canadian Chartered Accountant*. This general session, as the preceding and succeeding ones also, was well-attended, so much so that the double doors of the room leading to an adjoining chamber had to be kept wide open to accommodate all who wished to hear. Following the three papers on taxation problems there was a lively discussion from the floor and many sidelights were raised on the matters under discussion.

The final general session on Thursday afternoon was under the chairmanship of Mr. K. J. Morrison, O.B.E., F.C.A., Calgary, first vice-president of the Association. The topic was "Problems of the Auditor of Proprietorships and Closely-Held Companies". Mr. J. Harold Stewart, C.P.A., president of the American Institute of Accountants, delivered an excellent *ex tempore* address on the activities of the American Institute designed to assist the practitioner in this field. A paper prepared by Mr. J. R. M. Wilson, F.C.A., of Toronto, entitled "The Difference in Emphasis between the Audit of a Closely-Held Company and the Audit of a Publicly-Owned Company" was delivered in Mr. Wilson's unavoidable absence by his partner Mr. J. Grant Glassco, O.B.E., F.C.A., also of Toronto. Lieut.-Col. P. F. Seymour, C.A., of Montreal, read a paper on "What Is an Audit?" and Mr. F. A. Nightingale, C.A., Halifax, a past president of the D.A.C.A., read a paper entitled "The Extent of the Detailed Examination Necessary in the Course of an Audit". The subject, close to home as it was, in an audience of accountants, was productive of considerable discussion following delivery of the papers.

At the annual general meeting of the Association held on Friday morning, August 25, By-law 5 of the Association was amended, in accordance with the notice of motion published in the July issue of *The Canadian Chartered Accountant,* to provide that the *ex officio* members of Council shall be the president

and the two vice-presidents, and thus no longer include the treasurer. At this meeting it was agreed that an amendment to the Act of incorporation of the Association should be sought to provide that the name be changed to "The Canadian Institute of Chartered Accountants".

At its Friday meeting Council elected the following officers and appointed the following committee chairmen for the 1950-51 year:

OFFICERS

President—K. J. MORRISON, Alberta
1st Vice-President—A. E. BEAUVAIS, Quebec
2nd Vice-President—LORN MCLEAN, British Columbia
Immediate Past President—H. R. DOANE, Prince Edward Island
1st Regional Representative—W. J. MACDONALD, Manitoba
2nd Regional Representative—J. GRANT GLASSCO, Ontario
Treasurer—H. P. HERINGTON

COMMITTEE CHAIRMEN

Accounting and Auditing Research—K. LEM. CARTER
Education and Examinations—J. A. DE LALANNE
Board of Examiners-in-Chief—D. J. KELSEY
Legislation—G. P. KEEPING
Uniform Regulatory Legislation—R. W. MANNING
Magazine and Publications—R. F. BRUCE TAYLOR
Public Relations—DANIEL SPRAGUE

The Committee on Accounting and Auditing Research reported that Bulletin No. 4, "Accounting for Bad Debt Losses", had been issued during the year and that a further bulletin, "The Meaning of the Term 'Cost' ", had been approved for publication. In addition, two further topics are presently under study: depreciation and the meaning of the term "market" as used in inventory valuation.

Two bulletins dealing with auditing topics are being prepared. The first entitled "The Auditor's Report" will deal with the meaning of the word "audit", the necessity of making an adequate examination in order to justify the expression of an opinion, the extent to which the auditor can rely on internal control, and the test nature of most auditing procedures. It is hoped also to recommend a form of auditor's report for use in reporting on the accounts of limited companies under the *Companies Act, 1934* (Canada). The second auditing bulletin seeks to answer the question "Do the words 'as determined and certified by the management' appearing on a balance sheet in connection with the valuation of an inventory relieve the auditor from responsibility for the validity of the inventory figure?"

The Council approved the expenditure of $2000 to finance the preparation and publication by the Committee on Accounting and Auditing Research of brochures on accounting and auditing procedures for certain specific Canadian industries. Another recommendation contained in this report which was approved by Council asked for additional assistance to enable the Secretary and Research Director to devote more time to his duties as Research Director.

The Committee on Education and Examinations reported that starting with the fall 1950 examinations the final papers will be reclassified as two subjects Auditing and Accounting. The examination will consist of three papers in each subject and a pass mark will be a total of 180 marks in each subject. Candidates passing in one subject only will be granted a supplemental in the other subject and this privilege of rewriting one subject only will hold good for the next three succeeding examinations.

The Sub-Committee on Personnel Selection reported on the results of the sample testing and recommended that the programme be put into operation as soon as possible. In this

connection the British Columbia Institute reported that their experience during the past year in which their personnel selection programme had been in operation proved that such a programme was an extremely valuable aid in the selection of student personnel.

The Council approved a recommendation of the Committee on Education and Examinations that a full-time director of education be retained to develop and keep under review a uniform course of instruction, provided the Ontario Institute is agreeable to making its course available for the purpose and that Queen's University is retained to administer and revise the course. If such a plan appears to be feasible the costs thereof will be carried by the Institutes making use of the uniform course.

The Legislation Committee reported on the preparation and submission of the recommendations for amendments to the *Income Tax Act* jointly with the Taxation Committee of the Canadian Bar Association and of the submissions rendered in connection with the original subsection 4 of Regulation 1100 issued under the Act. The Committee proposes to prepare, jointly with the Committee on Accounting and Auditing Research, recommendations for the amendment of the *Companies Act, 1934* (Canada).

The Committee on Magazine and Publications reported that the circulation of *The Canadian Chartered Accountant* had risen by May 31, 1950 to the record high of 8,980, an increase of 791 during the year. During the year ten issues of *The Tax Review* were published, that is, in each month except July and August. It is proposed to continue this publication along the same lines as at present but it is intended that those decisions of the Income Tax Appeal Board which involve no new or important point of tax law will be dealt with in much briefer fashion.

Council approved a recommendation that a study should be undertaken to ascertain the functions of and need for public accountants in both rural and urban areas with a view to determining whether the profession is best serving the public interest and if not, how it can be improved to do so. Council also arranged for the formation of a standing committee to study the form and presentation of governmental accounts.

The reports of the various committees which were presented to Council will be published in full in the 1950 edition of the *"white book"*, as will be the audited financial statements, the membership and Institute summary and the Institute reports.

Letters from Readers

Statements of Account

Ottawa, Sept. 5, 1950

Sir: I have just read the report in your May issue of the panel discussion on confirmation of receivables and inventory; and also what one of your correspondents said about the former (see p. 221 of the May issue).

Here is a notice similar to that to which he took exception:

> PLEASE EXAMINE this statement carefully. If it does not agree with your records at the date indicated, please report any differences DIRECTLY to our auditor—
>
> LEGER deMAIN
> *Chartered Accountant*
> 802 Wabash Street
> Toronto, Ontario
>
> If no differences are reported to our auditor, this statement will be considered correct.

I do not think there is any need to get excited about it because I am sure it has no legal significance. What I am concerned about is what takes place in the C.A.'s office when I report a difference. In January I wrote to a very prominent firm of C.A.'s with regard to one such difference of $300 odd. Five months and four letters later I had not received an acknowledgment or a corrected statement.

Also, what happens to such statements which go to larger firms who pay by invoice rather than statement? Most of them evidently do not attempt to reconcile their suppliers' statements. In the case of suppliers' statements for goods shipped to branches the centralized accounts payable department at head offices would not have the remotest idea as to whether or not a statement was correct. Not one of them has ever taken exception to my own company's statements although it often has been necessary subsequently to make adjustments. Just yesterday we received an apron accounts payable cheque from a Montreal firm to pay four April invoices. In the meantime we have issued several others and I can't help but wonder if they have recorded the liability.

My feeling is that many of the companies throw away statements of account and an ever growing tendency is evident to discontinue to send monthly statements. A bad practice, in my opinion, but we receive at least one notice every month from suppliers who intend to adopt this course.

From our own experience I should say that a generous sampling with a form letter for confirmation would be better than a 100% mailing of statements with stamped notices.

E. WARDLE
Sec.-Treas., Keyes Supply Co. Ltd.

Re: Comment and Opinion "Conundrum"

August 1950 Issue

Sir: In Britain, a company, if authorized by its articles, may issue redeemable preferred shares, provided *inter alia* that redemption may only be effected out of profits which would otherwise be available for dividends, such amount to be transferred to a special capital redemption reserve fund.

Under British law an unrealized capital profit is not available for dividends and what will be apparently accomplished in this case will be a tax exempt distribution of cash to the shareholders out of earned surplus as shown below. (See p. 173.)

Since the creation of this capital reserve redemption fund is the statutory method of redeeming redeemable preferred shares in Britain it requires no elaboration and it is of course only set up at the time of the redemption of the shares *in due course.*

T. P. MILLER, C.A., F.C.I.S.

BALANCE SHEET

(before)

Cash	£300,000	Capital stock	£100,000
Other Assets	200,000	Capital reserve	91,000
		Earned surplus	309,000
	£500,000		£500,000

(after)

Cash	£250,000	Capital stock	£100,000
Other Assets	200,000	Capital redemption reserve fund	50,000
		Capital reserve	41,000
		Earned surplus	259,000
	£450,000		£450,000

JOURNAL ENTRIES

Debit: Capital reserve	£50,000	
Credit Redeemable preferred stock		£50,000
Bonus issue of redeemable preferred stock out of capital reserve		

Debit Earned surplus (available for dividends)	£50,000	
Credit Capital redemption reserve fund		£50,000
appropriation made in connection with proposed redemption of redeemable preferred stock on . . .		

Debit Redeemable preferred stock	£50,000	
Credit Cash		£50,000
Redemption		

Obituaries

Ralph E. Young

The Institute of Chartered Accountants of Ontario announces with regret the death of Ralph E. Young at Oakville on July 22, 1950 in his 78th year. Mr. Young commenced his accounting career with his father, Maitland Young, C.A., in Hamilton and was admitted to the Ontario Institute in 1897. He succeeded his father as auditor of the Canada Life Assurance Company and served in this capacity for 50 years. Mr. Young was very active in Institute affairs and was made a Fellow in 1909. In 1911 he was elected President of the Institute. Keenly interested in church affairs he was a member of St. Jude's Anglican Church and was for many years a lay delegate to the Synod of Niagara. He served as an officer with the Royal Grenadiers during World War I. In 1933 he was elected a Life Member of the Institute. To his wife and the members of his family the Institute extends sincere sympathy.

Harry R. Smyth

The Institute of Chartered Accountants of Ontario announces with regret the death of Harry R. Smyth at Toronto on July 25, 1950 in his 53rd year. Mr. Smyth was born in Toronto and entered business with Edwards, Morgan & Company, Chartered Accountants. Moving to Montreal, he became a member of the Quebec Institute of Chartered Accountants in 1923. He joined the Ontario Institute by affiliation in 1944. During the second World

War he served as assistant controller of the Department of Munitions and Supply, Ottawa. In the latter part of the war he was with the Polymer Corporation in Toronto and Sarnia. Subsequently he was executive director of De Havilland Aircraft of Canada Ltd. For the past few years Mr. Smyth had been controller of the Hospital for Sick Children. To his wife and family the Institute extends sincere sympathy.

Albert R. McMichael

The Institute of Chartered Accountants of Ontario announces with regret the death of Albert R. McMichael at Peterborough on September 5, 1950, in his 64th year. Mr. McMichael was born in Toronto and attended Trinity College. He graduated in Classics in 1908 and became a student-in-accounts with Wilton C. Eddis, Chartered Accountant. He became a chartered accountant in 1912 and later was a partner in the firm of Wilton C. Eddis & Sons with whom he was associated during his entire business career. Mr. McMichael served on the Instruction Committee of the Institute and was a member of Council for several years. He was the author of the annual publication of Musson Book Company Limited known as "Your Income Tax". To his wife and family the Institute extends sincere sympathy.

Frederick Henry Hutchinson Smith

The Institute of Chartered Accountants of Saskatchewan announces with deep regret the death on July 28, 1950 of Frederick H. H. Smith. Mr. Smith became a member of the Institute in 1920 and had been in public practice since that time. He was a member of the Council of the Institute and served for several years on the Board of Examiners.

To his widow and family the members of the Institute extend their deepest sympathy in their bereavement.

James Watt Taylor

The Institute of Chartered Accountants of Ontario regrets to announce the untimely death of James Watt Taylor, F.C.A., in Toronto on September 22, 1950 as a result of a motor car accident on September 10.

Born in Old Cumnock, Ayrshire, Scotland, in 1887, he came to Montreal in 1906 to enter the service of the Bank of British North America. In 1912 he joined the Montreal staff of Price, Waterhouse & Co., Chartered Accountants. In the First Great War he first saw active service with the Canadian Overseas Military Forces and later was granted a commission in the Fifth Gordon Highlanders of Scotland. He was twice wounded. On the conclusion of hostilities he returned to the Montreal office of Price, Waterhouse & Co. and in due course qualified as a chartered accountant by examination and became a member of the Institute of Chartered Accountants of Quebec. In 1922 he was transferred to the Toronto office and was admitted to the Ontario Institute in 1924. In 1929 he became a partner in Price, Waterhouse & Co. At the time of his death he was senior partner in Toronto.

For a number of years Mr. Taylor served on the Council of the Ontario Institute and was president in the year 1939-40.

To his widow and family the members of the Institute extend their deepest sympathy in their bereavement.

Professional Notes

ALBERTA

Mr. M. F. Mackenzie, C.A., announces the opening of an office for the practice of his profession in the Scott Block, Red Deer, Alta.

BRITISH COLUMBIA

P. S. Ross & Sons, Chartered Accountants, announce the opening of an office at 1207 Royal Bank Bldg., Vancouver, and the admission to partnership of Mr. J. L. Carter, C.A., as resident partner of the office.

• • •

McIntosh, McVicar & Dinsley, Chartered Accountants, 514 Standard Bldg., Vancouver, announce the admission to partnership of Mr. D. A. L. Tait, B. Com., C.A.

MANITOBA

Laird, Sprague & Co., Chartered Accountants, announce the removal of their offices to 704 Trust and Loan Bldg., 173 Portage Ave. E., Winnipeg.

NEW BRUNSWICK

P. S. Ross & Sons, Chartered Accountants, announce the admission to partnership of Mr. George Smith, C.A. Mr. Smith will be resident partner of their Maritimes office at 94 Prince William St., Saint John.

* * *

Hudson, McMackin & Co., Chartered Accountants, announce the opening of an office in Fredericton under the direction of Mr. William McNichol, C.A., as resident partner.

ONTARIO

Ontario Students' Association

The Council of the Chartered Accountants Students' Association of Ontario announces that Mr. J. K. Walker has been elected president of the Association for the balance of the term of the present administration. Mr. Peter Stewart was elected secretary of the Association to fill the position formerly held by Mr. Walker.

The Summer Stag of the Association was held at the 48th Highlanders Hall, Toronto, on August 24. Mr. W. B. Stapells, a member of the Association's Council, outlined the purpose of the proposed study groups. Prizes were presented to the following winners the sport tournaments:

Golf: Jack Vigeon (low gross)
Don McClelland (low net)
Tennis: John Shortly
Baseball: McDonald, Currie & Co.

The next social event of the Association will be a dance to be held in November at the Palace Pier, Toronto.

SASKATCHEWAN

Mr. W. T. Scott, C.A. announces that he has acquired the interest of Mr. W. S. Ronald, C.A., in the firm of Ronald, Griggs & Co., Chartered Accountants, 104 Grain Bldg., Saskatoon, and that henceforth the practice of the profession will be conducted under the firm name of W. T. Scott & Co., Chartered Accountants.

News of Our Members

The Institute of Public Administration of Canada at its annual meeting held in Toronto on September 16, 1950 elected as members of its Council the following members of the D.A.C.A.: Philip T. Clark, Controller of Revenue, Ont.; H. A. Cotnam, Provincial Auditor, Ont.; Chas. J. Ferber, Deputy Comptroller General, B.C.; Robert S. FitzRandolph, Comptroller General, N.B.; C. K. R. Huckvale, Provincial Auditor, Alta.; Gordon W. Hunter, Dept. of Trade and Commerce, Ottawa; G. D. Iliffe, Comptroller General, Man.; Wm. E. Massey, Deputy Provincial Treasurer, P.E.I.; F. A. R. MacFadden, City Auditor, Belleville, Ont.; L. E. Peverill, Provincial Auditor, N.S.; Lactance Roberge, Director of Finance, Montreal; Watson Sellar, Auditor General of Canada, Ottawa; R. F. B. Taylor, Foreign Exchange Control Board, Toronto; C. S. Walters, Deputy Provincial Treasurer and Controller of Finances, Ont.

George F. Davidson, Deputy Minister of National Welfare, Ottawa, was elected president and the 33 other members of council fill important positions in federal, provincial and municipal services and in universities.

* * *

Mr. Francis G. Winspear, C.A., Winspear, Hamilton, Anderson & Co., Chartered Accountants, Edmonton, Alta., has been elected president of the Canadian Chamber of Commerce.

* * *

Mr. Peter W. Bennett, O.B.E., C.A., has retired from partnership in George A. Touche & Co., Chartered Accountants, Toronto, as of September 30 and has accepted a responsible position with W. H. Smith & Son, Ltd., London, England.

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

THE accounting student of today has to consider two common forms which an income statement in fact takes. The first begins with sales revenue, deducts cost of goods sold, to arrive at gross trading margin, next deducts selling and administrative expenses to arrive at net trading margin, and then deducts financial and non-recurring expenses and adds items of subsidiary revenue to come to net profit. This form of income statement is the familiar one illustrated in all text books and required in accounting exercises and presumably is intended for management.

The second common form is that which is presented to shareholders in the annual report. It usually contains only the detail required specifically by the Companies Act under which the concern in question is incorporated, and begins rather abruptly with "Profit for the year before deducting the undernoted charges".

As between the two forms, the first is clearly the more informative: none of our Companies Acts requires, for example, a disclosure of sales revenue. It is therefore pointless to argue whether the first form mentioned (showing sales, cost of goods sold, gross trading margin, etc.) is the more useful from the point of view of the shareholders because in practice the shareholders do not receive it. Nevertheless the question remains whether this form is the most useful to management and for the administration of company affairs.

We can think of two other forms in particular which have been suggested. Some accountants now maintain that no one class of expense (such as cost of goods sold) has any logical claim to priority over any other expense. All expenses rank equally as costs of obtaining the revenue for the period. We imagine these accountants would applaud statements something like the one which follows:

Revenue:		
Sales	$ —	
Dividends and interest received from investments	—	
		$ —
Expenses:		
Cost of goods sold (per schedule attached)	—	
Advertising	—	
Salesmen's salaries	—	
Office salaries	—	
Office supplies	—	
Insurance—office buildings	—	
Taxes on real estate	—	
Depreciation of office buildings	—	
Depreciation of office equipment	—	
Addition to allowance for bad debts	—	
Loss on disposal of fixed assets	—	
Bond interest	—	
Estimated income tax exexpense	—	
		—
Net profit for year		$ —

The other form and the one that interests us at the moment, is one which would attempt to distinguish between those expenses that vary with the output of the concern and those that are fixed regardless of the scale of business activity during the accounting period. This form of income statement is referred to briefly by Professor Leo A. Schmidt in his article in *The Journal of Accountancy* for November 1949, "Uses of Formal Logic in Accountants' Daily Work".

In the case of manufacturing concerns, however, the classification of all expenses as either variable or fixed does seem to introduce a special problem. A single all-inclusive figure for "cost of goods sold" combines some manufacturing expenses which are variable and some which are fixed. Accordingly it would appear to be necessary to incorporate into the income statement the data usually available separately in the manufacturing statement. This in turn requires a knowledge of the proportions which material cost, direct labour cost and factory service costs command in the valuation of inventories of work in process and finished goods. The manufacturing cost components may then be adjusted for opening and closing inventory costs as a preliminary to including them in the income statement. With this complication mentioned, our suggestion as to the form of such an income statement follows.

SALES REVENUE		$ —
Deduct Expenses which tend to vary with output:		
Direct labour	$ —	
Raw materials	—	
Semi-variable factory service costs (factory supplies, indirect labour)	—	
Advertising	—	
Salesmen's salaries	—	
Office salaries	—	
Office supplies	—	
Addition to allowance for bad debts	—	
Estimated income tax expense	—	
		—
CONTRIBUTION TO FIXED COSTS AND PROFIT		—
Deduct Expenses which do not tend to vary with output (net):		
Insurance — office and factory buildings	—	
Taxes on real estate	—	
Depreciation of office and factory buildings	—	
Depreciation of machinery	—	
Depreciation of office equipment	—	
Bond interest	—	
Loss on disposal of fixed assets	—	
	—	
Less dividends and interest received from investments	—	
		—
Net profit for the year		$ —

SOLUTION TO LAST MONTH'S PUZZLE

$ 95.67
10.85
$106.52

PUZZLE

Here is an opportunity to see if you can follow complicated-looking instructions. If you persevere, you will have learned a useful technique for multiplying any number by any other number containing two digits. With a little practice you will be able to multiply numbers quickly, writing down the product directly from the numbers to be multiplied.

The problem is to multiply 6852 by 19 following the instructions given below.

(Note: 6852 is the "multiplicand"; 19 is the "multiplier"; 2 is the "unit digit" of the multiplicand; 5 is the "tens digit" of the multiplicand, etc.; 9 is the unit digit of the multiplier, and 1 is the tens digit of the multiplier; the product of any digit in the multiplicand times any digit in the multiplier is called a "partial product"; the product of the multiplicand times the multiplier is called the "final product".)

(a) Take the unit digit of the product of the unit digit of the multiplier times the unit digit of the multiplicand as the unit digit of the final product to be obtained;

(b) Add the tens digit of the partial product just obtained in (a) to the sum of the products of the unit digit of the multiplier times the tens digit of the multiplicand, and the tens digit of the multiplier times the unit digit of the multiplicand. Take the unit digit of this partial product as the tens digit of the final product to be obtained;

(c) Add the tens digit of the partial product just obtained in (b) to the sum of the products of the unit digit of the multiplier times the hundreds digit of the multiplicand, and the tens digit of the multiplier times the tens digit of the multiplicand. Take the unit digit of this partial product as the hundreds digit of the final product to be obtained;

(d) Add the tens digit of the partial product just obtained in (c) to the sum of the products of the unit digit of the multiplier times the thousands digit of the multiplicand, and the tens digit of the multiplier times the hundreds digit of the multiplicand. Take the unit digit of this partial product as the thousands digit of the final product to be obtained;

(e) Add the tens digit of the partial product just obtained in (d) to the product of the tens digit of the multiplier times the thousands digit of the multiplicand. Take this partial product as the ten thousands digit and hundred thousands digit of the final product to be obtained.

(Adapted from "The Mechanism of Numbers" by Harry Kelly in *The Journal of Accountancy* July 1921. A detailed solution will appear next month.)

CORRESPONDENCE

Saint John, N.B.

Sir: I wish to offer the following comments with respect to the solution given to Problem 3, Accounting II which appears in the July issue of *The Canadian Chartered Accountant.*

(1) *Book loss on old machines*:

In my opinion the amount of depreciation accumulated on the old machines and therefore the book loss on the trade-in of such machines has no significance whatsoever in arriving at a decision as to whether it would be advisable to purchase the new machines. The only significant items are the annual cost of the new machines and the reduction in future out-of-pocket expenses of operation which would result from their purchase. The book loss on the disposal of the old machines is the balance of a sunk cost which is irrelevant to the question.

(2) *Cost of operating old machines*:

The solution given shows depreciation of $9,000 a year as part of the cost of the old machines which is calculated by dividing the original cost of these machines by the estimated life. In a problem of this nature it is the cash or trade-in value of the old assets that must be taken into the calculation. Although this cash value might be divided by the number of years of life remaining in the machines to obtain an annual cost, it is my opinion that this amount should be offset against the cost of the new machines before calculating the annual cost of such new machines.

(3) Accepting the other calculations given in the solution, the following is the solution I would present to part (a) of the question:

Annual Costs:	Old Machine	New Machine
Operators	$15,552.00	$ 7,680.00
Maintenance	1,800.00	1,000.00
Depreciation — $\frac{70,000 - 6 \times 2500}{10}$	——	5,500.00
	$17,352.00	$14,180.00

Annual Saving if new machines purchased is $3,172.00 *without* allowing for any interest on the additional outlay.

(4) Although a statement in the above form is required by the question it is my opinion that a more satisfactory way of presenting information of this nature to management is as follows:

Cost of operating old machines	$17,352.00
Cost of operating new machines	8,680.00
Annual saving in out-of-pocket expenses	$ 8,672.00
Additional Capital Outlay required	$55,000.00
Number of years required to recover additional investment	6.3 years

With the above information (which excludes depreciation from the cost of operation of both old and new machines) the management can decide whether the investment is warranted. In making such a decision they will of course consider the estimated life of the new machine, the possibility of the new machine becoming obsolete at an earlier date, whether funds can be spared, and a number of other intangible factors.

A. W. BELL, C.A.

Toronto, Ontario

Sir: On studying your solution to Question 3, Accounting II, Intermediate Examination, November 1948 appearing in the October 1949 issue of *The Canadian Chartered Accountant,* I am of the opinion that the treatment of O. Faith's withdrawals is incorrect.

The Question states in item 6 that "O. Faith has withdrawn only his salary and bonus *during the 5 years.*" But, the partnership has been in operation for only 4 years. Since Faith would not know how much his bonus was during the year it was earned, he would withdraw it in the following year. On the other hand, he does know how much his salary will be for each year, and he will withdraw it during the year it was earned. This would lead me to believe that Faith withdrew only his salary in 1945, and his bonus applicable to the 1945 profits in 1946. Thus, he would withdraw his bonus applicable to the 1947 profits on January 1st, 1948, making a total of 5 years' withdrawals, as the question states. If this is the case, the bonus and interest on capital for 1946 and 1947 will be different from that shown in the solution.

MELVIN A. SALAK

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect of course the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, October 1949

Accounting II, Question 5, (12 marks)

The following transactions took place in connection with a fund which was originated on 1 Jan 1948:

(a) 1 Jan 1948, deposited in the fund $50,000.

(b) 1 Mar, purchased bonds at par $20,000, interest payable 1 Mar and 1 Sept @ 4%. Due 1 Mar 1965.

(c) 1 June, purchased bonds; interest payable 1st June and 1st December @ 5%. Par $20,000; discount $2,000; bonds due 1st June 1958.

(d) 1 July, purchased bonds; interest payable 1 Mar. and 1 Sept. @ 6%. Par $10,000; premium $1,000; plus accrued interest. Bonds due 1 Mar. 1958.

(e) 31 Dec, trustees paid $200 expenses.

(f) All interest was received when due. Bonds purchased are to be recorded at par and the premiums or discounts amortized.

Required:

(a) The journal entries to record the foregoing transactions, and to adjust the accounts as at 31 Dec 1948.

(b) Balance sheet of the fund as at 31 Dec 1948.

Note: Carry all computations to the nearest dollar.

A SOLUTION

(a)

Jan.	1—Fund Cash	$ 50,000	
	General cash		$ 50,000
	Deposit in fund.		

Mar.	1—Bonds	20,000	
	Fund cash		20,000
	4% bonds purchased; interest payable 1st Mar. and 1st Sept. Due 1 Mar 1965.		

June	1—Bonds	20,000	
	Discount on bonds		2,000
	Fund cash		18,000
	5% bonds purchased; interest payable 1st June and 1st Dec. Due 1 June 1958.		

July	1—Bonds	10,000	
	Premium on bonds	1,000	
	Accrued interest	200	
	Fund cash		11,200
	6% bonds purchased; interest payable 1st Mar. and 1st Sept. Due 1 Mar 1958.		

Sept.	1—Fund cash	700	
	Accrued interest		200
	Interest income		500
	Interest received on 4% bonds—$400. Interest received on 6% bonds—$300.		

Dec. 1—Fund cash	500	
Interest income		500
Interest received on 5% bonds.		

Dec. 31—Accrued interest	550	
Interest income		550
Interest accrued on 4% bonds $267.		
Interest accrued on 5% bonds $83.		
Interest accrued on 6% bonds $200.		

Expenses of fund	200	
Fund cash		200
Trustees expenses paid.		

Dec. 31—Discount on bonds	117	
Interest income		117
$\frac{7}{120}$ x 2000 of discount amortized.		

Interest income	52	
Premium on bonds		52
$\frac{6}{116}$ x 1000 of premium amortized.		

(b)

FUND BALANCE SHEET
As at 31 Dec 1948

Cash		$ 1,800
Accrued interest receivable		550
Investments at par:		
4% bonds due 1 Mar 1965	$ 20,000	
5% bonds due 1 June 1958	20,000	
6% bonds due 1 Mar 1958	10,000	50,000
Premium on bonds-unamortized		948
		$ 53,298
Discount on bonds unamortized		$ 1,883
Due General fund:		
Original deposit	50,000	
Interest income	1,615	
	51,615	
Less expenses	200	51,415
		$ 53,298

PROBLEM 2

Final Examination, October 1949

Accounting III, Question 6 (10 marks)

Explain briefly how the following items would be dealt with in determining the taxable income of a limited company:

(a) Loss on realization of temporary investments.
(b) Legal expenses incurred in acquiring lease of premises for occupancy for business purposes.
(c) Upkeep of company-owned house occupied rent-free by managing director.
(d) Amortization of bond discount.
(e) Cost of appraisal of company's fixed assets.
(f) Operating loss sustained in immediately preceding year.
(g) Change in method of valuation of inventories from FIFO to LIFO.
(h) Loan to a shareholder.

A SOLUTION

(a) Unless its business was trading in securities for a profit this would be a non-allowable loss.
(b) Ordinarily allowed as an expense of year incurred but may have to be amortized over life of lease.
(c) As an expense.
(d) Not allowed as an expense.
(e) Not allowed as an expense.
(f) If loss of preceding year was greater than the income of the next preceding year, the difference could be brought forward to reduce the taxable profit of the current year. This is providing that the loss has been calculated in accordance with the provisions of the Act.
(g) At the moment the LIFO method of cost determination is not generally recognized by the Department of National Revenue so income for tax purposes would have to be calculated using the FIFO basis.
(h) Under the old act, a loan or advance to a shareholder unless in the ordinary course of business was deemed to be a dividend in his hands to the extent the company had undistributed income, for tax purposes, on hand. Under the *Income Tax Act*, a loan or advance to a shareholder is deemed to be a dividend in his hands unless the loan was made in the ordinary course of business and lending money was part of the ordinary course of its business, or to an officer or servant of the corporation to enable or assist him to purchase a dwelling house for his own occupation or fully paid shares of the corporation to be held by him for his benefit.

PROBLEM 3

Final Examination, October 1949

Accounting III, Question 7 (20 marks)

On 30 June 1949, Axil Lent, domiciled in Canada, one of the partners of Lowd & Lent, died after a lengthy illness. At that date, the trial balance of Lowd & Lent was as follows for the year then ended:

	Dr.	Cr.
Cash	$ 70,000	
Accounts Receivable	150,000	
Allowance for bad debts		$ 13,000
Inventories	108,000	
Fixed Assets	180,000	

Payment on account 1949 income tax:		
Al. Lowd	5,000	
Axil Lent	5,000	
Allowance for depreciation		80,000
Accounts and notes payable		45,000
Al. Lowd—Capital Investment		100,000
Al. Lowd—Drawings		15,000
Axil Lent—Capital Investment		210,000
Axil Lent—Drawings		10,000
Profit and Loss		45,000
	$ 518,000	$ 518,000

Each partner has paid the premium and is the beneficiary of a life insurance policy with a face value of $100,000 on the life of the other partner. The cash surrender value of the policy on Lent's life is $45,000, and on Lowd's life is $50,000 as at 30th June 1949.

The terms of the partnership agreement provide that upon the death of either partner, the surviving partner shall take over the business and pay to the estate of the deceased partner an amount equal to the deceased partner's interest. It may be assumed that the figures on the books reflect the fair value in all cases.

Mr. Lent was a married man and had 3 children—Avery age 25, Gala age 17, and Cyrus age 15.

Mr. Lent's will made the following bequests:

$1,500 to his church,
5,000 to Canadian Cancer Society,
2,000 to Canadian Red Cross,
1,000 to Boy Scouts,
5,000 to University of Larnin.

The rest of his property, after payment of all debts and proper charges, was left to his wife.

Besides his interest in the partnership, Mr. Lent owned the following:

(a) The family home which has an estimated market value of $60,000 and is assessed by the municipality at $40,000. The house was purchased by Mr. Lent in 1930 for $20,000, and deeded to his wife in 1939.
(b) The contents of the house, valued at $40,000.
(c) 3% Dominion of Canada bonds, par value $50,000, market value $49,000, purchased in April, 1945, interest due 31st March and 30th September. Mr. Lent has always given his wife the income from these bonds.
(d) Industrial stocks, cost $61,400, market value $85,000.
(e) House and land, estimated market value $30,000, assessed at $20,000, purchased in 1942 at a cost of $12,000, leased to a tenant at an annual rental of $3,600 payable quarterly in advance on the 1st of March, June, September and December. Expenses, including depreciation, from 1 Jan to 30 June 1949, amounted to $1,310.
(f) Cash on hand and in bank, $3,100.
(g) Account receivable of $2,000 owing by Mrs. Lent's brother. In his will Mr. Lent extinguished this debt.

On 1 Oct 1939, Mr. Lent gave his nephew $5,000 in Dominion of Canada bonds upon his enlistment in the navy. These bonds have a present market value of $4,900.

On 15 June 1947, Mr. Lent gave each of his children $10,000 in Canadian Corporation Bonds on which he paid gift tax amounting to $3,500. These bonds have a present market value of $8,000.

When Mr. Lent first became ill on 1 Apr 1948, he gave to his son, Avery, 3% Dominion of Canada bonds in the amount of $60,000 with interest due 31 Mar and 30

September. It was understood that Avery would return these bonds if his father recovered. These bonds have a present market value of $58,800.

Dividends on the industrial stocks were received by Mr. Lent's estate as follows:

(a) $3,400 which was declared on 1 June payable to shareholders of 15 June, payable 30 June.

(b) $2,800 which was declared on 1 July from profits earned in year ended 31 March.

Funeral expenses amounted to $1,100. Probate fees on the estate amounted to $9,300. Mr. Lent's other liabilities at 30 June 1949, amounted to $8,750.

Note:—For the purposes of this problem, the applicable income tax rate may be assumed to be 35%.

Required:

The "aggregate net value" of the estate for the purposes of Dominion Succession Duties. Show in detail how you arrived at this amount.

A SOLUTION

Net Aggregate Value of Lent's Estate
as at 30 June 1949

Value of Lent's share in partnership		
Capital investment		$ 210,000
Drawings		10,000
Profit and Loss—½ of $45,000		22,500
		242,500
Less prepayment on income taxes		5,000
Interest in partnership		237,500
Insurance policy on Lowd's life, cash surrender value		50,000
Contents of home		40,000
3% Dominion of Canada bonds	$ 49,000	
Accrued interest—3 months	375	49,375
3% Dominion of Canada bonds (Avery)	58,800	
Interest 15 mos. @ 3% on $60,000	2,250	61,050
Industrial stocks—market value		85,000
House and land leased to tenant		30,000
Accounts receivable from Mrs. Lent's brother		2,000
Dividends receivable		3,400
Cash on hand and in bank		3,100
Canadian corporation bonds given to children		24,000
Total assets		$ 585,425
Less debts and allowances:		
Rent paid in advance—2 mos. @ $300	600	
Funeral expenses	1,100	
Probate fees	9,300	
Income tax, 1st Jan. to 30th June 1949	3,921.50	
Other liabilities	8,750	23,671.50
Net aggregate value:		$561,753.50

Calculation of income tax to 30th June 1949:

	Income from partnership — ½ of $45,000		$ 22,500
	Dominion of Canada bonds—3% for 6 mos.		750
(x)	Dominion of Canada bonds held by Avery — 3% for 6 mos.		900
	Rental from house — 6 mos. @ $300	1,800	
	less expenses including depreciation	1,310	490
	Dividends		3,400
	Total income:		$28,040
	Less exemptions—		
	Married status	2,000	
	Cyrus	150	
	Gala	400	2,550
	Taxable income		$ 25,490

Tax at 35%	$8,921.50
Less prepayment	5,000.00
Tax Payable	$3,921.50

(x) *Note*: Corporation bonds transferred to Syrus and Gala: Under Income War Tax Act any 1949 interest would be taxable against Lent's estate since they are both minors. Sec. 32(1).
Under Income Tax Act, Section 22, interest on bonds transferred to Cyrus only would be taxable against Lent's estate.

PROBLEM 4

Final Examination, October 1949

Accounting III, Question 8 (6 marks)

State the classification under which each of the following should appear on the balance sheet of a manufacturing company as at 30 June 1949, and give your reasons.

(a) Advances to subsidiary.
(b) Reserve for contingencies.
(c) Inventory reserve for future price declines.
(d) Deficit.
(e) Accounts receivable payable in 1952 arising from sale in 1948 of machinery no longer required.
(f) Unamortized premium on bonds to be redeemed in 1950.

A SOLUTION

(a) Under heading of investments, but separate from the investment in subsidiary, if the advances are in the nature of loans because the effect of such advances is to increase the investment in the subsidiary. If, however, the advances are current accounts owing by the subsidiary, the amount is better shown as an account receivable but separate from other trade accounts receivable.

(b) Under heading of surplus because this is simply an amount appropriated from surplus, but remaining a part of the shareholders' equity until the contingency arises.

(c) Under heading of surplus because this is simply an amount appropriated from surplus but remaining a part of the shareholders' equity.
(d) Deducted from capital. This is a reduction of the shareholders' equity.
(e) As a separate item after current assets, or, alternatively, included with accounts receivable, but shown in a footnote to be due in 1952. Unless this is done, the reader of the statement will consider the amount to be ordinary trade accounts and credit ratios, etc., will be inaccurate.
(f) Should be shown as a deferred credit. This amount may be used to offset the interest expense on the bonds.
or Should be added to the par value of the bonds and shown with long-term liabilities, so that there is extended as the bond liability the amount of money of which the company has the use, and on which the company is paying interest at the effective rate.

HOW THE ENGLISH BALANCE SHEET GOT ITS FORM

From the North American point of view the perverse nature of the British people may be readily inferred from the side of the road they drive on and the side of the balance sheet they list assets on. We have recently encountered an interesting apology for British balance sheet practice. It can be traced, it now appears, to the old days of the "T" ledger account in which a debit balance was identified first as a deficiency of credits and inserted *as of the closing date* on the right hand side of the account to balance things up. Then the account would be ruled off and the balance "brought down" *as of the opening date* of the following period on the debit side. (This method of balancing will be familiar since it is still retained in many accounting texts as a teaching expedient.) The point is, we learn, that since the balance sheet is at the closing date, the British really have been quite logical in placing assets on the right hand side of the balance sheet because the balances of asset accounts as of the closing date appear on the right hand side of their accounts. The corollary of this is of course that North Americans are illogical in basing their balance sheet position of items on the location of the balances in the accounts as of the opening date of the following period! However, working from the hypothesis that nothing we do *could* be illogical, we would point out that the "T" form of ledger account ruling is now largely obsolete.

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